Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of	)	
	)	
Comment Requested on a La Carte and Themed	)	
Tier Programming and Pricing Options for	)	MB Docket No. 04-207
Programming Distribution on Cable Television	)	
And Direct Broadcast Satellite Systems	)	

COMMENTS OF CONSUMERS UNION, and CONSUMER FEDERATION OF AMERICA

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INTRODUCTION

TV viewers today are forced to live in a world of the cable industry's making – extremely limited choice and endlessly spiraling prices. With no meaningful government oversight and virtually no competition, cable providers—with the exception of being required to carry broadcast channels—decide what programming consumers see by controlling both packaging and price. By placing their most popular channels in expensive tiers with other channels most people don't watch or find offensive, the industry forces consumers to pay a special "cable tax" by requiring them to buy bloated packages of channels in order to get the programming they actually do want.

Consumers Union[1] and Consumer Federation of America[2] believe that cable operators get away with this manipulation simply because they can. Competition is virtually non-existent – 98 percent of Americans have only one cable provider – and there are only two satellite television companies in the nation, one of which has extensive ties to the cable and broadcast industries. Satellite also must purchase its programming from the same cable and broadcasting giants, leaving satellite customers to buy similarly large tiers of channels. The attached report prepared by Dr. Mark Cooper, Research Director of the Consumer Federation of America (CFA), entitled "Time to Give Consumers Real Choices" provides a comprehensive economic analysis of the cable and satellite programming markets.

The only other market powerhouses are the large broadcast companies that own over-the-air and cable TV channels. Their control of popular network programming enables them to package their entire channel lineup and force these channels onto cable and satellite systems – and ultimately the consumer. This lack of competition has led to staggering price increases. According to the Bureau of Labor Statistics, cable customers have helplessly watched their bills increase by 56 percent since the industry was deregulated in 1996.

Consumers who want choice and value are stuck. And creators of new and diverse programming find themselves in the same situation. The only way to get their programming out to the public is to put it under the control of huge cable companies or broadcast media conglomerates to package with their media giant's programming. This situation stifles diversity of ownership and programming by blocking independent access to cable systems. Indeed, today very few channels are independent or controlled by women and people of color. Those that do exist are under the firm control of the cable barons' or broadcast media giants' control.

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[1] Consumers Union is a nonprofit membership organization chartered in 1936 under the laws of the state of New York to provide consumers with information, education and counsel about goods, services, health and personal finance, and to initiate and cooperate with individual and group efforts to maintain and enhance the quality of life for consumers. Consumers Union's income is solely derived from the sale of *Consumer Reports*, its other publications and from noncommercial contributions, grants and fees. In addition to reports on Consumers Union's own product testing, *Consumer Reports* with more than 4 million paid circulation, regularly, carries articles on health, product safety, marketplace economics and legislative, judicial and regulatory actions which affect consumer welfare. Consumers Union's publications carry no advertising and receive no commercial support.

[2] The Consumer Federation of America is the nation's largest consumer advocacy group, composed of over 280 state and local affiliates representing consumer, senior, citizen, low-income, labor, farm, public power an cooperative organizations, with more than 50 million individual members.

We imagine a cable world where choice is allowed and diverse programming encouraged. Cable and satellite would offer both packages of channels and individual channels on an *à la carte* basis Rather than having to dig deeper into their pockets just to get the channels they want, consumers have the option to pick and choose their channels, grouping together those they want, instead of paying for those they don't watch or find offensive. Local broadcast channels that serve community needs and interests would be preserved on a "basic" tier of programming, along with national broadcast networks that meet a "public interest" test by providing diverse viewpoints on matters of national and global importance. And locally oriented public, educational and government (PEG) programming would be adequately funded and preserved in this basic tier. Independently-owned and public interest channels would be promoted alongside those owned by the major media corporations and new and diverse content providers would find an easier path to getting their programming out to the public. This is the world of cable *à la carte* that Consumers Union and CFA believe should be, and will be, the future of cable television.

CABLE: A HISTORICALLY ANTI-CONSUMER INDUSTRY

Cable television's upward pricing spiral reflects a major failure of market forces and public oversight since Congress launched cable deregulation in 1996.[5] In that time, cable rates have ballooned nearly three times faster than the rate of inflation. According to the Bureau of Labor Statistics (which even adjusts cable price increases by crediting the industry when it adds channels), rates have shot up a staggering 58 percent since January 1996, while inflation increased by only 21 percent during the same time.[6]

When price increases are not adjusted to give cable "credit" for adding new channels — many of which are barely watched — consumers find themselves paying prices that have risen five times faster than inflation (see attached report, p. 1, 23). It's clear that the hoped-for competition from deregulation has failed to materialize to temper prices.

To justify these skyrocketing prices, cable/satellite operators and programmers have used recent contract negotiations to engage in an unprecedented round of public finger-pointing.[8] Cable operators and satellite providers blame the programmers, saying they charge too much for

[5] Public Law 104-104, The Telecommunications Act of 1996.

[6] Bureau of Labor Statistics, Consumer Price Index (May 2004). From 1996 until March 2004, CPI increased 21.2% while cable prices rose 58.2%, 2.7 times faster than inflation.

[8] Eisenach, Jeffrey A. and Douglas A. Truehart, *Rising Cable Rates: Are Programming Costs the Villain?*, supported by ESPN, Inc., October 23, 2003 (hereafter ESPN); Economists Inc., *Consumer, Operator, and Programmer Benefits from Bundling Cable Networks*, July 2002; Rogerson, William P., *Cable Program Tiering: A Decision Best and Properly Made by Cable System Operators, Not Government Regulators*, November 10, 2003, funded by Cox (hereafter Cox); *Correcting the Errors in the ESPN/CAP Analysis Study on Programming Cost Increases*, November 11, 2003, prepared for Cox Communications (Cox II)

channels. Programmers blame the cable operators, saying they raise prices under the guise of providing advanced video and non-video services to customers. The finger pointing merely attempts to hide the real issue – facing no competition or oversight, cable companies can jack up their monthly cable rates with impunity.

Part of the problem is clearly related to the special "cable tax" that industry places on consumers by forcing them to buy expensive bundles of channels to receive the programs they actually want. To purchase the channels they most want, consumers must buy large service tiers from cable operators ranging from 40 to 75 channels or more. As the General Accounting Office noted, recent Nielsen Media Research data show the average consumer watches about 12-17 channels regularly,[9] and many of those channels are different for each person and family.

Right now, cable customers must first buy a basic cable tier, as previously provided by Congress, to ensure availability of local broadcast and national network channels. That package is usually kept small and may be price regulated. It is separate from other tiers, and Congress requires that cable operators allow basic service subscribers to buy pay-per-view (PPV) and premium channels like HBO and Showtime individually on an *à la carte* basis.

Beyond the basic package, however, cable operators engage in aggressive anti-consumer bundling of channels. The next tier, expanded basic, has grown steadily in size and cost over the years, increasing about two-and-a-half times as quickly as the basic tier in the past four years. It now contains three times as many channels as the basic tier. Expanded basic is also a required purchase if a consumer wants to buy digital service. A digital package is also large, consisting of roughly 30 channels, and in many markets the digital service alone costs more than the basic service. If consumers want Video on Demand (VOD) services, they also must purchase the digital tier.

As previously mentioned, Nielsen ratings data show that most consumers' viewing are concentrated among a small group of channels. The top 10 cable networks account for 50 percent of all viewing, and the top 20 channels account for 75 percent of all such viewing. Since the GAO reports that the typical household watches only 17 channels, consumers are forced to buy a lot of channels they don't watch in order to get the ones they do want.

Although the bottom 30 channels on the Nielsen scale pass an average of just under 70 million homes, only about a quarter of a million households watch them during any given day. For every one household watching, approximately 250 households who are forced to pay for those channels in the bundle are not. For the bottom two channels, the ratio is 1 to 800. Over 250 additional cable networks do not capture enough viewers to even register on the Nielsen scale.[10] If cable companies can offer distribution to channels with such limited viewership and little or no advertising support today, why would they be any less likely to carry the same channels in a world where cable tiers are accompanied by the offer to purchase individual channels?

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[9] GAO-04-08, Issues Related to Competition and Subscriber Rates in the Cable Television Industry, October 2003.

[10] The explanations that cable industry executives gave the GAO for the social welfare superiority of bundling assume that advertisers irrationally pay for homes passed, rather than eyeballs watching, and that consumers maximize their welfare by subsidizing their neighbor's viewing habits. (U.S. GAO, 2003, pp. 34-37). Those claims are inconsistent with the data in the attached paper, "Time To Give Consumers Reach Choices: Twenty Years Of Anti-Consumer Bundling And Anticompetitive Gatekeeping."

TASTE AND PROGRAMMING: THE INDUSTRY IS IN CHARGE

The immense public furor generated by January's Super Bowl halftime incident involving entertainer Janet Jackson illustrates the overwhelming desire of American consumers to have some control over the programming that comes into their homes. While technology such as the V-Chip allows consumers to block distasteful programming, many cable TV consumers find themselves paying for the very programming they find offensive or indecent.

Congress attempted to address the decency issue by dramatically hiking fines on broadcasters of indecent content. However, that approach does not apply to cable and satellite programmers, who are not subject to the same public duties as over-the-air broadcasters. And although these fines might help to slightly stem the tide, as *Kansas City Sta*r television critic Aaron Barnhardt told a reporter from the *Marketplace Morning Report*, "In the time it will take for you to report this story, Viacom (which distributes *The Howard Stern* Show) will make enough profit to pay off all of its FCC fines and then some."[11]

Giving consumers the choice to select only those cable channels they want provides a different solution to the growing public concern about violent and indecent programming. Rather than putting the government in the untenable position of trying to control cable content for taste and decency, consumers could merely choose the programming they want, eliminating from their homes those channels which they find offensive.

DIVERSITY IS NOT WELL-SERVED BY CABLE AND MEDIA BARONS

The current cable model also shuts out those independent, diverse programmers who would like to offer their content to the public without being beholden to media gatekeepers that own or control a large bundle of channels. Six companies completely dominate the cable programming landscape of the basic and expanded basic tiers, accounting for three-quarters of the programming and writing budgets of the video industry. But these aren't just any six companies. Each of them is also a national network broadcaster, a cable or satellite operator, or has significant ties to both.

Of the 63 channels that reach more than half the cable viewers in the nation, only a half dozen are not owned by one of six dominant firms. According to the FCC's Tenth Annual Cable Report, of the top 20 cable channels measured by subscribers and top 15 cable channels measured by primetime viewership, only one, The Weather Channel, is not owned by a cable operator, a broadcast network or the cable industry.

Consider the dominance these companies have over the broadcast airwaves and cable/satellite viewers:[12]

- **Disney** owns the broadcast network ABC, broadcast stations and cable networks such as ESPN, Lifetime, A&E, History Channel, and SoapNet.

[11] Marketplace Morning Report, July 1, 2004.
[12] Cooper, p. 36.

- **Viacom** owns broadcast networks CBS and UPN, local affiliates reaching almost 39 percent of the American television viewing audience, and cable channels including MTV, BET, Comedy Central, Nickelodeon, Showtime, Spike TV, CMT, and VH1.

- **Time Warner** owns the second largest cable company in the country, and owns The WB broadcast network, and cable channels including CNN, Headline News, HBO, Court TV, TBS, TNT, and Cartoon Network.

- **General Electric** owns broadcast network NBC and local broadcast outlets as well as cable networks Bravo, USA, Sci-Fi, Trio, CNBC, and MSNBC.

- **NewsCorp** owns the Fox broadcast network, local affiliates of both Fox and UPN reaching about 39 percent of the American TV viewing audience, national DBS satellite operator DirecTV and cable channels Fox News, FX, National Geographic and more than a dozen Fox Regional Sports networks.

- **Liberty Media & Comcast**, the largest single shareholder of NewsCorp, owns a few cable systems and through previous merger transactions, has guaranteed carriage for many of its networks like The Hallmark Channel, Discovery, Animal Planet, QVC, Starz, and TLC on the largest cable operator in the country, Comcast.[13] With 23 million subscribers Comcast also owns a significant stake in channels like TV One, E!, The Golf Channel, Outdoor Life Network, G4 (the successor to TechTV) and regional sports networks serving three of the nation's six largest metropolitan areas—Chicago, Baltimore-Washington, and Philadelphia.

The General Accounting Office found that cable companies discriminate in favor of their own programming: they are much more likely to carry channels that they have an ownership interest in.[14] that leaves independent and small programmers with a simple take it or leave it proposition. They either must acquiesce to the cable operator's demands in order to be included on their lineup, or starve.

Stephen Cunningham, CEO and president of start-up channel JokeVision, summed up his network's fate with a morbid sense of humor: "Have you heard the one about the cable programmer who paid no attention to a Comcast suggestion? He's not around any more."[15]

One programmer that has had some success paying attention to Comcast is TV One, which is significantly owned and controlled by the large cable company. Comcast made it clear during their negotiations with various African-American entrepreneurs including Russell Simmons and Tim Reid that they had to have a stake in whichever channel they might carry.[16]

It's no wonder that network executives say these barriers are high when, "combined with industry consolidation, which has left a handful of powerful MSOs (Multiple System

[13] *TV Week*, Diane Mermigas, "Comcast Courting Bornstein," November 18, 2002.
[14] GAO-04-08, p. 1
[15] *Cable World*, "New Networks Face The VOD Taste Test," Andrea Figler, June 30, 2003.
[16] *Multichannel News*, "Comcast's Clout: Giant MSO Flexes its Muscle with Nets," R. Thomas Umstead November 25, 2002.

Operators—a cable company) controlling the vast majority of cable subscribers, the current environment is arguably the worst ever to launch a new linear video service."[17]

In a world where big broadcast programmers control much of the cable dial, and cable operators are extracting as much money from independent programmers as possible, it's hard to imagine it could be any more difficult for independent programmers to get on cable systems. As start-up network consultant Cathy Rasenberger notes: "The majority of networks out there have no chance at all. That doesn't mean there isn't opportunity for some new networks. The eye of the needle has become a lot smaller, but if you've got a refined piece of thread you can still get through. You have to match up with the cable operators' objectives – and even if you do, you still may not have an opportunity."[18]

Consider the dearth of programming offered to African-American consumers on expanded basic. There is only one national cable channel (BET—owned by Viacom) that targets African-Americans, and another channel (TV One) mostly available to Comcast subscribers. Most other African-American themed channels are offered only on unnecessarily pricy digital tiers.

But according to the Cable Television Advertising Bureau, "Urban black households are the most television-oriented as compared to all other groups." They go on to say "Premium channel subscription in urban cable homes is greater among black and Hispanic subscribers as compared to white and Asian subscribers."[19]

Now if we had *à la carte*, more African-American themed and owned channels could be created and offered to consumers of color. And if we had *à la carte*, then African-American consumers, like all consumers, could select and pay for the programming they want without paying for unnecessarily pricy expanded basic tiers and other bundles.

Since *à la carte* encourages consumer choice, cable operators should be encouraged to provide niche and targeted audience markets with two or more channels instead of the one they own. This notion that *à la carte* offerings will prompt more diverse programming is supported by the recent introduction of video-on-demand service.

Cable operators now offer programmers the opportunity to prove themselves and sell their content on a stand-alone basis as video-on-demand. After the cable operators have collected about $60 per month from subscribers and force-fed them the first 90 plus channels on expanded basic and the digital tier, independent programmers have the opportunity to compete for the discretionary income and viewer attention that might be left. We believe consumers

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[17] *Multichannel News*, "New Nets Abundant at National Show; Fledgling Services Find Entry Into Digital-Cable Realm Difficult," R. Thomas Umstead, May 3, 2004.
[18] *Cable World*, "Attention New Networks! Here's everything you need to know about how to get a carriage deal with Comcast...step by step from Amy Banse and Matt Bond," Shirley Brady, June 21, 2004.
[19] Cable TV Advertising Bureau: Multicultural Marketing Resource Center. "Psychographics and Cultural Insights," Urban Markets in the US, Horowitz Associates.
[22] Canada imposes a variety of content regulations that we believe are unnecessary and inappropriate for the US market. We cite the Canada example for the purpose of showing how à la carte can work and what prices it offers in a real-world example.

should have the choice to access these new and diverse channels via an *à la carte* option without paying the "cable tax" that the current regimen of bundled channels requires.

À LA CARTE: A SOLUTION TO CABLE'S PROBLEMS

The cable industry's current business model of requiring consumers to purchase two expensive packages of channels just to get the small amount of programming they actually may watch is simply unfair. This model not only sticks consumers with a "cable tax" for these bundles, it puts up unnecessary roadblocks to new and diverse programmers trying to get their content on the cable and satellite systems.

The regulatory intervention we propose to solve this anti-consumer, anti-competitive model is far from intrusive. Rather than try to dictate channel bundles, or ban them, we propose allowing cable operators to continue to offer all the bundles they want, but also make the channels they choose to bundle available on an *à la carte* basis.

Unbundling beyond the basic tier can create new demand among consumers for content not currently carried by their cable operator. Because the cable company won't have to worry about mainstream acceptance of niche and targeted content, and because both cable operator and programmer can earn revenue from selling to consumers as many channels as they want to watch — not just what they can shoehorn into a bundle — cable companies are free to serve those niches with as many channels as a consumer could want.

Consumers Union and Consumer Federation of America would prefer to let competition be the solution to cable rate increases. However, in light of the failure of effective competition to materialize, and given the relentless price increases, the special "cable tax" on consumers due to bundling of channels, the lack of consumer control, the roadblocks that prevent independent programmers from getting cable space, and the abusive practices described in the attached report, we believe it is time for policymakers to release the stranglehold cable and broadcast giants have on the marketplace by encouraging an *à la carte* option.

À LA CARTE WORKS: ASK CANADIAN CONSUMERS

When those in the American cable industry try to raise feasibility arguments about the *à la carte* option, they need only look to their colleagues in Canada to realize their claims are baseless. Nearly all the major Canadian cable operators are offering their bundled programming on an *à la carte* basis, and some cable operators, most notably Vidéotron, offer the kind of system that we envision for the United States.[22]

Consumers in Canada must first subscribe to basic and digital cable and rent or buy a converter box, and then they select their programming in ways American consumers can only dream about. Vidéotron customers, for example, first buy basic Canadian digital cable that includes roughly 20 TV channels (the company offers those, along with 30 music channels, and 14 broadcast radio stations for $8.25).[23] Once a digital converter box is purchased for $45 after a rebate, or rented for $9 per month, the consumer is in control. Vidéotron offers three general bundles, numerous themed bundles, and the option to purchase channels individually -- 38

[23] All conversions from CAD to USD obtained from http://finance.yahoo.com/currency, 07/01/2004.

channels for $20 per month (the equivalent to the American expanded basic tier), 65 channels for $28 and 106 channels for $40, (their equivalent to various U.S. digital tiers).

But Vidéotron customers' choice doesn't stop there. The cable operator offers bundles of channels with programming focused on news, sports, documentaries, sitcoms, culture, lifestyle and music. It also lets consumers pick a bundle of programming in French or English. And if a consumer wants a channel that isn't part of the bundle they've selected, then most channels will let Vidéotron sell it to their customers individually for $1 per month, a per-channel price that drops if a consumer orders 5, 10 or 20 other channels.

Some Vidéotron programmers don't want their channel offered individually, and demand it only be sold in a bundle with other channels. If that's what a customer really wants, then Vidéotron steers them to a bundle of 20 or 30 channels that a consumer selects — a bundle Vidéotron calls "*à la carte*." This is the kind of package that Canadian Cable Association President Mike Hennessey calls a "pick pack." Vidéotron offers 93 channels and allows consumers to select 20 or 30 of them in that bundle. A Vidéotron spokesman told the Orlando Sentinel, "We have noticed that some people prefer to pay for what they want to look [at]."[24]

We believe that cable operators in the United States are prevented from following the *à la carte* options offered by their Canadian counterparts' because of restrictive provisions in programming contracts. We believe that all channels beyond the basic tier should be unbundled, and let cable operators decide in what ways to package and bundle them in addition to offering them on an individual, *à la carte* basis.

CABLE *À LA CARTE* WORKS IN A DIGITAL WORLD

Unfortunately, what little the diversely owned and independent programming that currently exists is only available to consumers if they purchase expensive digital packages. While millions of American homes subscribe to cable, most buy analog cable packages of basic and expanded basic programming that includes channels owned either by cable operators, broadcasters or other media conglomerates, but very little ethnic or independent programming. Seventy percent of cable's customers don't get digital, and therefore don't have access to most of the ethnic, targeted, niche or independent programming cable does offer. We believe that unbundling cable channels will encourage the transition to digital cable.

Although the large majority of cable households purchase analog, it might not be economically feasible in the next few years to offer *à la carte* to those consumers. Sending a cable technician to an analog customer's home each time a channel is added or removed is not cost-efficient. But cable operators have moved to, and are aggressively promoting digital, a technology that not only offers them more channel capacity but also the technical feasibility to unbundle content in new ways.

Currently, there are 23 million digital cable subscribers and 20 million Direct Broadcast Satellite (DBS) subscribers who receive digital service — which means 40 percent[25] of U.S. households are instantly capable of accessing *à la carte*, or unbundled content**.** The advent of

[24] Orlando Sentinel, "À la carte Cable Could Redefine Pay-Per-View," Susan Strother Clarke, June 6, 2004.
[25] U.S. Census Bureau, USA Quick Facts, 2004.

inexpensive digital converter boxes and the increasing availability of digital cable-ready television are helping bridge the gap between digital and analog cable. But policymakers must also prevent the growth of a digital divide, where low-income consumers cannot afford the digital entry price to receive *à la carte* options. To achieve this, digital set-top boxes should be made affordable to all consumers in an *à la carte* environment.

CONSUMERS WANT *À LA CARTE*

Recent nationwide surveys conducted by Consumers Union and the Concerned Women for America demonstrate that consumers want increased choice and more control over their cable programming, and their cable bills.

According to the CWfA poll, conducted by Wirthlin in April 2004,[26] more than two-thirds of cable customers would prefer to choose the channels in their cable packages, and less than a third are satisfied with the channel bundles they're currently offered. And approximately the same percentage of Latinos and African-Americans would prefer to choose their own channels. The poll found among non-cable subscribers, 66 percent would be more likely to subscribe to cable if they had control over their programming.

Consumers Union found similar sentiments in our national survey of cable subscribers conducted in May 2004[27]. We found that 66 percent of subscribers would prefer the option to pick only those cable channels they want to watch or have included in their service plan. We also asked consumers about possible drawbacks of unbundling cable content, including channel selection and price. Of those surveyed, 59 percent would pick fewer channels than they currently must buy in their cable package. And 29 percent would *still* choose fewer channels even if their cable bill didn't decline proportionally.

STEPS FOR THE COMMISSION

Congress has appropriately directed the FCC to investigate the central policy questions affecting the adoption of *à la carte* by beginning the inquiry with questions about revenue generation. The central questions the Commission posed are:

- What would be the impact on retail rates to consumers if programmers were required to offer their programming to MVPDs (Multichannel Video Programming Distributors—like cable and satellite) exclusively on a stand-alone basis and could not also offer programming on a bundled basis for free or at a discounted rate?
- What would be the impact on retail rates to consumers if programmers, in addition to the currently offered packages, were required to allow MVPDs to offer their programming on an *à la carte* or themed-tier basis if the MVPD chose to do so?
- How would an *à la carte* or theme-tiered approach affect a networks' ability to attract advertising revenue? Would the impact change depending upon whether an MVPD subscriber had to purchase a basic/expanded basic tier before purchasing additional channels on an *à la carte* basis? How would *à la carte* or themed-tier option, in

[26] Wirthlin Worldwide, April 22, 2004, National Quorum for Concerned Women for America.
[27] Consumers Union, May 25, 2004, Cable TV Issues Survey.

addition to packages currently offered affect a network's ability to attract advertising revenue.

- What effect, if any, would the voluntary offering of *à la carte* or themed-tier service have on the ability of independent, niche, religious, and ethnic programming to continue to be carried or launched?

In order to answer these questions, it is essential for the Commission to obtain access to the contracts between cable operators and programmers.

As the attached study from Dr. Mark Cooper explains, these contracts determine the pricing of channels, lineup placement, bundling provisions and more.[29] The Commission should examine the language programmers use for big cable conglomerates and smaller, independent cable operators, and satellite providers. It should open these contracts for the public to evaluate who has the balance of power in these negotiations and if industry is preventing the choices that consumers deserve.

Policymakers should focus their analysis on what is known as mixed bundling – the offer to consumers of channel choices in both packages and on a stand-alone basis. Pure bundling, in which channels are offered only in packages, and pure component selling, in which packages are outlawed, have consistently been found in the economic literature to be inferior. The policy question is, why has the cable industry resisted mixed bundling so fiercely? We believe the answer is that its reliance on pure bundling within tiers is anticompetitive and anti-consumer, and a detailed examination of those practices would reveal consumers are stuck with the industry's special cable tax.

In our view, the current rate structure reflects the exercise of substantial market power by the cable operators who engage in bundling to extract monopoly profits and control the flow of content. Under these circumstances, if consumers were offered the opportunity to choose between bundles and an *à la carte* menu of the same programs, it is likely that the total rate paid by consumers for the channels they would choose to purchase will be reduced and consumer satisfaction would increase.

Large cable operators, mega-broadcast programmers and advertisers have become comfortable with the current system because the inefficiencies and excess profits of the system are shifted onto the backs of consumers. As consumers pay more than their fare share to get the channels they want, cable operators and powerful programmers engage in minor skirmishes over the division of monopolistic profits, and put up roadblocks to unaffiliated programmers. The cable operators collect the tax, pay excessive amounts to large broadcasters in the form of high fees for some channels and guaranteed carriage for others, and dictate which programs the public can view, while forcing them to pay for large numbers of channels they do not watch.

If the FCC can force manufacturers to rebuild entire classes of technology to fight piracy and adhere to Plug and Play specifications, and if the FCC can plant a Broadcast Flag in its goal

[29] Time To Give Consumers Reach Choices: Twenty Years Of Anti-Consumer Bundling And Anticompetitive Gatekeeping, Dr. Mark Cooper, Consumer Federation of America, p. 1, 23.

to expedite the transition to digital television, surely policymakers can also give consumers more choice in cable programming. It is time for Congress and the FCC to put consumers' interest on equal footing with industry goals and let market forces begin to provide much needed discipline on exorbitant cable rates. And it is also time for policymakers to empower consumers to keep distasteful programming out of their homes.

We urge policymakers to note what the industry itself said about *à la carte* pricing little more than a year ago. In testimony before the Senate Commerce Committee in March 2003, cable operators big and small endorsed pricing cable channels *à la carte*.

James Gleason, president and chief operating officer of CableDirect, a cable operator serving 20,000 customers in the Midwest said, "To give customers choice and allow the market to determine what gets on TV, programmers should be required to make their services available as part of a separate programming tier. One solution might be to offer the expensive programming in tiers or *à la carte*."[30]

Charles Dolan, chairman of Cablevision, one of the largest cable operators with over 4 million homes in the northeast, told the Senate Commerce Committee: "Cablevision, as a policy, wants its customers to be able to pick and choose among its services, selecting what appeals to them, rejecting what does not, determining for themselves how much they will spend, just as they do every day in the supermarket or shopping mall."[31] He continued with an analogy repeated since, "To help the dairy industry, I ask, would the government insist that all customers be required to buy a dozen eggs and a quart of milk before they can purchase their bread?"

In short, Congress and the FCC should abolish the "cable tax" the industry collects by forcing consumers to take tiers of programming that grow larger and more expensive each year. It should take the most prudent First Amendment approach to dealing with offensive programming by giving consumers the option not to have that programming come into their homes. And it should break the monopolistic power cable operators and large programmers have over what is offered to viewers over cable lines and satellite. By allowing the *à la carte* option, these important policy matters can be achieved with little to no government intervention.

[30] James Gleason, Testimony before Senate Commerce Committee, "Media Ownership (Video Markets)," May 6, 2003.
[31] Charles Dolan, Testimony before Senate Commerce Committee, "Media Ownership (Video Markets)," May 6, 2003.

Consumer Federation of America

TIME TO GIVE CONSUMERS REAL CABLE CHOICES

AFTER TWO DECADES OF ANTI-CONSUMER BUNDLING AND ANTICOMPETITIVE GATE KEEPING

MARK COOPER

JULY 2004

Contents

I. INTRODUCTION

A. Purpose of the Analysis

The relentless increase of cable rates at several times the rate of inflation and recent contract negotiations between cable operators and programmers[1] have stimulated an unprecedented round of finger pointing and release of industry data. The finger pointing has attempted to justify and/or place blame for the dramatically increasing price of cable service. Cable operators claim the programmers made them do it.[2] Programmers have fired back, suggesting that basic rates have been increasing to support the roll out of advanced video and new, non-video services.[3] Not only does the finger pointing and controversy drive home a simple point – consumers are paying a dramatically higher price for their monthly cable service – but it also places a spotlight on the cable practice of forcing consumers to buy large bundles of channels.

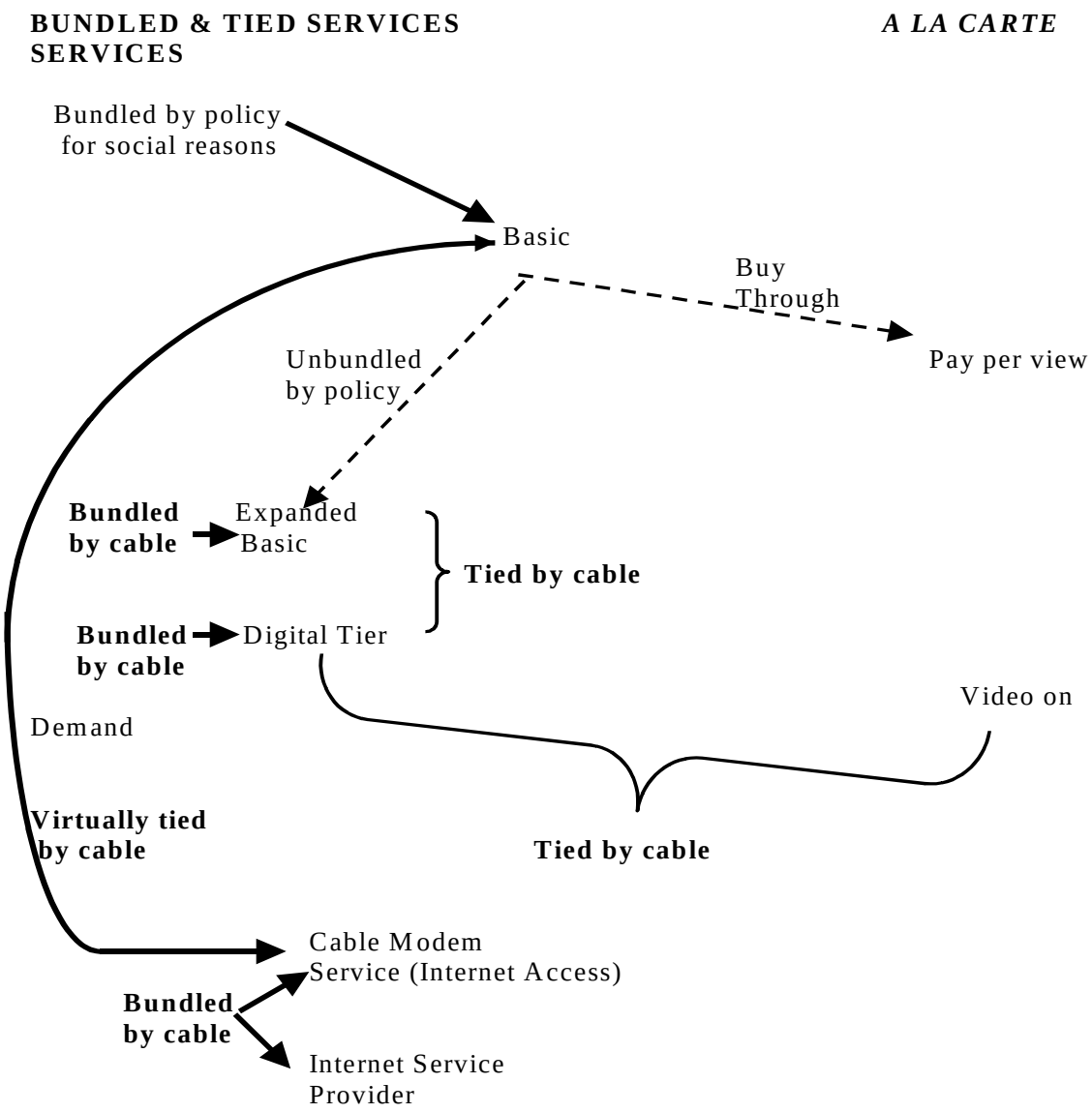
Cable offers consumers a narrow set of choices of bundled and tied channels and services (see Exhibits I-1). Households must buy basic service, with about 16 channels at a cost of about $19 per month (including equipment costs) to receive any video service. Once basic is purchased, the most popular cable programming is bundled into the "expanded basic" (or cable programming) service tier, which contains just under 50 channels, at an average cost of about $24 per month. This larger expanded bundle, which is taken by the majority of cable subscribers, is the focal point of the current pricing policy debate. It not only contains the most popular cable programming, it is the single largest source of cable revenue. Consumers are forced to buy all the channels or none. They must buy expanded basic to get digital tier service, which is itself a large bundle of about 30 channels at a price of about $20 (including equipment). In essence, cable operators force consumers to buy about 90 channels in three, large, all or nothing bites, at a total cost of about $65 per month.

Yet, the typical household watches about 17 channels, little more than one-quarter of the total of the basic/expanded bundles. Clearly, households are being forced by pay for many channels that they do not want.

This analysis demonstrates that the cable industry practice of forced bundling is anti-consumer and anticompetitive. Forcing consumers to buy large bundles of channels, most of which they do not watch, in order to gain access to the small number that they wish to view results in a higher total bill.

The cable operators' denial of consumer choice and control of programmers' access to the viewing public distort the video programming market. Cable operators overwhelmingly favor programs in which they have ownership interests; broadcasters use their carriage rights to gain preferential access to the public by forcing their way into the large bundles. As a result, independent programmers find it very hard to gain access to the market.

Exhibit I-1: The Cable Industry's Bundling and Tying Strategy



Moreover, because the current system inefficiently denies the consumer choice in purchasing programming, the advertising market is inefficient. Because consumers are forced to pay for dozens of channels that they do not watch, advertisers must pay for millions of blank TV screens. The possibility that someone might wander through a niche channel is not very valuable to advertisers, but there is no way to target marketing. Therefore, advertsiers should not be willing to pay much for time on unwatched channels, but the cable industry claims they are paying huge sums for unwatched commercials.[4]

Large cable operators, major national broadcast networks and advertisers have become comfortable with the current system because the inefficiency and excess profits of the system are shifted onto the consumer by the exercise of market power at the point of sale. Consumers dislike it intensely.[5]

This is essentially a system in which cable operators use their market power to impose a tax on consumers. They engage in minor skirmishes with the most powerful programmers over the division of the excess profits (monopoly rents) and foreclose access to the public for weaker, and unaffiliated programmers. The cable operators collect the tax, pay an excessive amount to large broadcasters in the form of high fees for some channels and guaranteed carriage for others and act as gatekeepers who dictate which programs can be viewed by the public.

Confronted with growing resistance to the tax, the cable operators now claim that part of the tax is used to subsidize diverse programming. [6] The argument does not stand close scrutiny. The system is remarkably inefficient at delivering the subsidy. The tax is far larger than any subsidy, if there is one. The system is remarkably ineffective in creating diversity. The system is inequitable to programmers. The system is unfair to consumers. The people who are taxed have no say in how the money is spent.

The system is broken. A simple requirement that cable operators offer consumer an *a la carte* choice of channels, in addition to any bundles they offer, would be a dramatic improvement.

B. Summary of Findings

1. Market Power 101

Section II summarizes the analytic framework used to examine market structure in economic analysis, as well as the unique public policy concerns in media industries.

In recent papers defending cable industry prices, cable industry economists have ignored the underlying market power possessed by the industry and focused on the scraps of consumer surplus left on the table by cable operators.[7] Consumers are willing to pay because the value of the service exceeds the price for them, but consumers are still paying too high a price for the service.[8] Also, there are some who give up cable or do not take it, when they would have, if the price had been at a competitive level. Their loss is a deadweight efficiency loss. Because the elasticity of demand is low, wealth transfers are large relative to efficiency losses.

Bundling can have a similar effect. In the situation where cable operators abuse their market power, bundled pricing compels consumers to pay a higher price for a larger bundle in order to receive the channels they really want. There are also some consumers who would buy a subset of the huge bundle cable operators refuse to offer on an *a la carte* basis.

2. Cable Market Structure

Section III describes the structural conditions of the multichannel video market that give the cable operators market power. Simply put, every indicator of market structure and econometric evidence suggests that cable operators have market power and are abusing it. There is little actual head-to-head competition between cable operators, but when there is, it lowers prices substantially. Only head-to-head competition from a second cable company significantly disciplines cable pricing. Unfortunately, fewer than 2 percent of Americans enjoy this form of competition. Larger systems and those pulled into regional clusters result in higher prices for consumers. Vertically integrated cable operators favor their own programming.

Intermodal competition between cable and satellite has failed to discipline cable's pricing power. Because satellite caters to a high value, high volume niche of the market, it is particularly unsuited to putting pressure on cable's anti-consumer bundling policies.

3. Gate keeping Discrimination

Section IV examines the practices that cable operators use to control the flow of programming that reaches the public. With the exception of the in-house programmers who are owned in whole or in part by cable operators and large broadcast networks, whose must carry/retransmission rights give them guaranteed access to carriage, cable programmers are faced with a simple take it or leave it proposition. They must acquiesce to the cable operator's demands in order to gain carriage in the expanded bundle, or starve.

Ironically, cable operators have begun to offer programmers the opportunity to prove themselves on a stand-alone basis in the video-on-demand space, but this provides little real opportunity. Simply put, **after the cable operators have collected over $60 per month from subscribers and chosen about 80 channels, independent programmers are offered the opportunity to compete for the scraps of discretionary income and viewer attention that might be left.**

As a result of these market distortions, six entities completely dominate the programming landscape, accounting for three-quarters of the channels that dominate prime time, programming expenditures and writing budgets of the video industry. They completely dominate the basic and expanded basic tiers. Of the 63 channels that reach more than half the cable viewers in the nation, only a half-dozen are not owned by one of the dominant six firms.

4. Severely Restricted Choice

Section V examines the impact of cable pricing on consumers. Consumers are offered a small number of large bundles. The basic service bundle has been dictated by Congress for social reasons, kept small and, because competition has failed to materialize, remains price

regulated. It is unbundled from other tiers by Congress, which requires that cable operators allow basic-only subscribers to purchase pay per view channels on an *a la carte* basis.

Beyond the basic package, cable operators engage in anti-consumer bundling and anticompetitive tying. The expanded basic tier has grown steadily in size and cost over the years. The cost of the expanded basic tiers has increased about two and a half times as quickly as the basic tier in the past four years. It now contains three times as many channels. The entire bundle is offered on a take-it-or-leave-it basis.

Expanded basic is tied to the digital tier. The consumer must buy expanded basic if he or she wants digital service. The digital service is also a large package, consisting of 30 channels, which are offered on a take-it-or-leave-it basis. It now costs more than basic (when equipment costs are included). Digital tier service is tied to video on demand. The consumer must buy the digital tier in order to purchase video on demand.

There is also a tie between cable modem and basic cable. Cable operators charge a negative, predatory price for basic cable service, when purchased with cable modem service. A consumer pays $55 to $60 for stand-alone cable modem service, but only $45 when cable modem service is purchased with basic cable. Cable modem service for Internet access is bundled with purchase of their Internet service provider (ISP). Consumers are forced to pay for cable's affiliated ISP, even if they want to keep their own ISP.

C. Recommendation

This analysis focuses on the problem in the current cable market structure and conduct. One solution, providing consumers with a choice between bundles and individual channels, is so simple and well justified in the economics literature that it hardly needs defending. "[T]he whole concept of efficient resource allocation is built upon the fundamental belief that the consumer is sovereign – that individual preferences are what count."[9]

Moreover, the possibility of anti-consumer bundling has long been recognized in static consumer welfare economics literature.[10] The recognition of the possibility of anticompetitive bundling in a dynamic or strategic sense is more recent, but no less important, especially as cable market power is "swung" into the high-speed Internet.[11]

In their more unguarded moments, even some cable industry experts admit that bundling can be harmful to consumers, but because they always give the benefit of the doubt to the cable operators, they advocate government inaction.

> It is easy to create examples where bundling can make consumers worse off but equally easy to create examples where bundling makes consumers better off… [A] fair characterization of the consensus view of economists at this point is that they simply do not know whether this type of bundling is likely to benefit or harm consumers. However, since regulation is costly and can create other distortions, the fact that this type of bundling cannot be shown to be

systematically harmful to consumers is sufficient reason for most economists to conclude that there is no reason to regulate this type of bundling.[12]

The conditions under which bundling results in consumer harm are well known, "related to a firm's motivation to try to charge different consumers different prices for the same product depending upon what they are willing to pay for it. The essential idea is that when there is some negative correlation between individual consumers' valuation of different products, that firm can sometimes charge higher prices to everyone by bundling goods together."[13]

Given the relentless price increases, the pattern of bundling and the abusive practices described in this analysis, we believe that cable operators have lost the benefit of doubt. Moreover, the regulatory intervention we propose is far from intrusive. Rather than try to dictate bundles, or ban them, we propose to allow cable operators to offer the bundles that they want, but also make the channels they choose to bundle available on an *a la carte* basis.

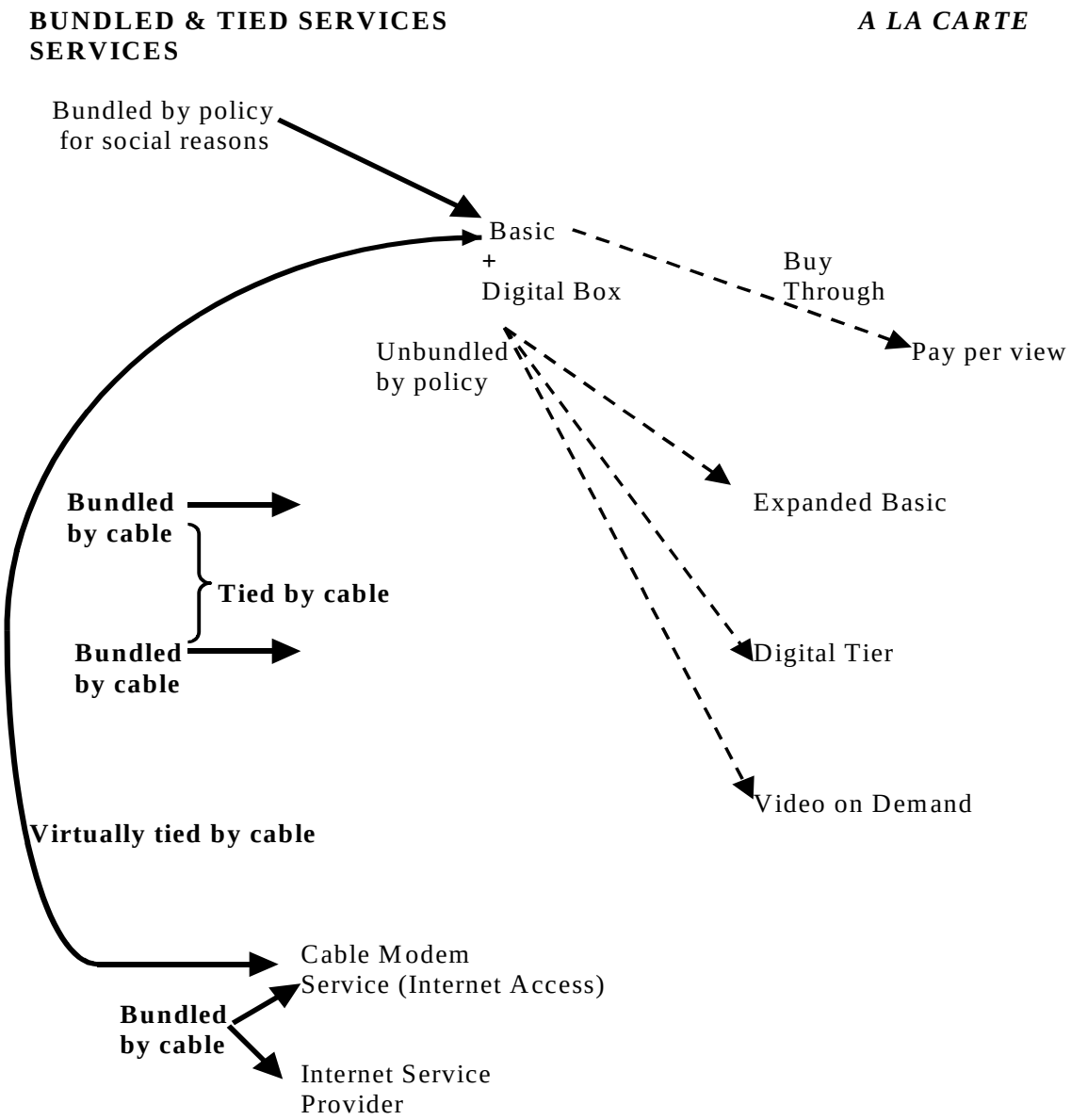
Thus, we recommend what is known in the literature as mixed bundling – the offer to select either channel packages and or channels on a stand-alone basis. Pure bundling, the situation in which programs are offered only in packages, and pure component selling, the situation in which packages are outlawed, have consistently been found to be inferior in the economics literature. The policy question before the Commission is why has the cable industry resisted mixed bundling so fiercely? We believe the answer is that the current rate structure reflects the exercise of substantial market power by cable operators who engage in bundling to extract consumer surplus, control the flow of content and increase their profit. Under these circumstances, if consumers were offered the opportunity to choose between bundles and an *a la carte* menu of the same programs, it is likely that the total rate paid by consumers for the programs they would choose to purchase would be reduced and consumer satisfaction would increase.

Introducing consumer choices would diminish the ability of cable operators to extract surplus. It would place downward pressures on programming costs, by forcing programmers to directly confront consumer willingness to pay. It would enhance the value of advertising on channels that consumers actually demonstrate a willingness to pay for. Moreover, it would diminish the power of cable operators to control who has access to the public by increasing the opportunity for independent programs to rise or fall on their merits, rather than on whether they conform to the interests of the cable operators.

The analysis shows that *a la carte* is a revolution that is long overdue in this industry because past efforts to control market power and diminish the gatekeeping leverage of cable operators have failed. The hopes that satellite, overbuilding, open video systems, and leased access would finally bring competition to the industry have all been dashed. Bundling is one of the central mechanisms the cable industry uses to exploit its market power at the point of sale.

In its simplest form, the proper mixed bundle for cable services extends the current "buy-through" approach to all tiers and programs (see Exhibit I-2). Consumers are required to buy basic and a digital box. The basic tier serves social functions as well as covering fixed costs associated with cable. The digital box allows the *a la carte* menu to be made available, as well as supporting the billing function. The transaction costs of *a la carte* are dramatically reduced in a digital environment, as they have been with the growth of the Internet.

Exhibit I-2: Breaking the Cable Industry's Bundling and Tying Strategy



Cable operators can create bundles, but the channels that are made available in bundles must also be made available on an *a la carte* basis. This analysis shows that the requirement to offer bundles and *a la carte* could have a number of salutary economic effects beyond the simple fairness of allowing consumers to pay for only the things they truly want to consume.

Because cable income from traditional video services has been growing much faster than cable costs (i.e., net income has grown), the requirement to make programs available on an *a la carte* basis can put downward pressures on prices.

Cable operators could feel pressures to be more responsive to consumer needs. In all likelihood, they will still want to sell bundles, but they will have to be more careful not to overprice them, thereby driving consumers to *a la carte* purchases. This discipline would be created by attacking the core driver of anti-consumer bundling, the negative correlation between demand for different channels. The ability to cross subsidize from traditional video service to other services would also be reduced.

Owners of the most expensive channels should feel pressures to control costs. The elasticity of demand for individual channels would become apparent in a mixed bundled world. The threat to remove channels from bundles, or segregate expensive channels into theme tiers, should expose programmers more directly to consumer preferences.

Because the current system is so discriminatory against independent programming, we believe that *a la carte* could expand the opportunity for independent programming.

Cable operators would come under pressure to remove their own shows from bundles, if the number of consumers who choose *a la carte* is significant, but the shows they choose are not owned by cable operators.

The ability of large national programmers to force large packages of channels into the expanded basic bundle could be put under pressure, if consumers show an *a la carte* preference for a small subset of its channels.

Programmers who achieve a significant *a la carte* following could gain considerable leverage with advertisers, since they are delivering a dedicated and perhaps distinctive audience.

We use conditional words – would, could – to describe these possible effects because the results will emerge from the interaction of three forces, cable operator interests, programmer interests and, to a much greater extent than ever, consumer preferences. We reject the claim that *a la carte* will fail to discipline cable behavior, like rate regulation did in the early 1990s. The 1992 Cable Act gave regulators a weak set of tools; *a la carte* rests on a much more powerful force, consumer sovereignty in the marketplace. It is undeniably pro-competitive and very likely to be consumer-friendly.

II. ANALYZING MARKET POWER

A. PROTECTING COMPETITION

Economic public policy is primarily concerned with market performance.[14] The concept of performance is multifaceted, including both efficiency and fairness.[15] The measures of performance to which we traditionally look are pricing, quality, and profits. The performance of industries is determined by a number of factors, most directly the conduct of market participants. Do they compete? What legal tactics do they employ? How do they advertise and price their products? Conduct is affected and circumscribed by market structure. Market structure sets the context in which economic actors behave. Market structure includes the number and size of firms in an industry, their cost characteristics and barriers to entry. Market structure is also influenced by basic conditions, such as the elasticities of supply and demand, vertical integration, as well as the constraints of available technologies.

Market structure analysis identifies situations in which a small number of firms control a sufficiently large part of the market to make coordinated or reinforcing activities feasible.[16] Through various mechanisms, a small number of firms can explicitly and implicitly reinforce each other's behavior rather than compete. Identifying when a small number of firms can exercise this power is not a precise science. Generally, however, when the number of significant firms falls into the single digits, there is cause for concern.

For the purposes of merger analysis, the Department of Justice has adopted *Merger Guidelines*, intended as a practical rule of thumb to indicate where the number of firms is becoming so small that concern about the exercise of market power triggers close scrutiny.[17] The DOJ uses a complex index called the Hirschman-Herfindahl Index (HHI) to describe concentration, while many economists refer to the four firm concentration ratio (CR-4).[18]

The simplest way to summarize the DOJ *Merger Guidelines* is to describe markets in terms of the equivalent of equal-sized firms (see Exhibit II-1).[19] For example, the DOJ considers a market with the equivalent of 10 or more equal-sized firms to be "unconcentrated" and is not likely to challenge mergers in such markets. In a market with 10 equal sized firms, the four largest firms would have a 40 percent market share and the HHI would be 1000. Markets with the equivalent of approximately 6 to 10 equal-sized firms are considered "moderately concentrated." In this range, the HHI falls between 1000 and 18000 in the DOJ Guidelines. Markets with the equivalent of fewer than 6 equal-sized competitors are considered highly concentrated and just about any merger is considered a source of concern. Such markets are considered tight oligopolies.[20] These thresholds are grounded in theoretical and empirical analysis.[21]

Exhibit II-1: Describing Market Structures

DEPARTMENT OF JUSTICE MERGER GUIDELINES	TYPE OF MARKET	EQUIVALENTS IN TERMS OF EQUAL SIZED FIRMS	TYPICAL HHI IN MEDIA MARKETS	4-FIRM SHARE
	MONOPOLY	1[a]	5300+	~100
	DUOPOLY	2[b]	3000 - 5000	~100
		5	2000	80
HIGHLY CONCENTRATED	TIGHT OLIGOPOLY		1800 OR MORE	
MODERATELY CONCENTRATED		6	1667	67
UNCONCENTRATED	LOOSE OLIGOPOLY	10	1000	40[c]
	ATOMISTIC COMPETITION	50	200	8[c]

a = Antitrust practice finds monopoly firms with market share in the 65% to 75% range. Thus, HHIs in "monopoly markets can be as low as 4200.

b = Duopolies need not be a perfect 50/50 split. Duopolies with a 60/40 split would have a higher HHI.

c = Value falls as the number of firms increases.

Sources: U.S. Department of Justice, *Horizontal Merger Guidelines*, revised April 8, 1997, for a discussion of the HHI thresholds; William G. Shepherd, *The Economics of Industrial Organization* (Englewood Cliffs, NJ: Prentice Hall, 1985), for a discussion of four firm concentration ratios.

B. Promoting Diversity in Civic Discourse

While the public interest standard of the Communications Act includes considerations of economic efficiency and the desire to promote competition, it adds other public policy concerns. For example, Title VI of the Communications Act, which governs cable communications, establishes six purposes, only one of which involves competition. In fact, competition is mentioned last on the list. Also identified are long standing Communications Act goals of localism and diversity. Thus, included on the list are directives to the Federal Communications Commission to implement policies that:

> encourage the growth and development of cable systems and which assure that cable systems are responsive to the needs and interests of the local community…

> assure that cable communications provide and are encouraged to provide the widest possible diversity of information sources and services to the public.[22]

This language paraphrases the Supreme Court wording that has been used to define First Amendment aspirations for development of civic discourse in modern America. Justice Black used this key expression in the seminal case of *Associated Press*:

> "The First Amendment rests… on the assumption that the widest possible dissemination of information from diverse and antagonistic sources is essential to the welfare of the public, that a free press is a condition of a free society. Surely a command that the government itself shall not impede the free flow of ideas does not afford non-governmental combinations a refuge if they impose restraints upon that constitutionally guaranteed freedom. Freedom to publish means freedom for all and not for some."[23]

Since then, Congress and the Supreme Court have reaffirmed this view with respect to newspapers[24] and the Court has applied it to all forms of electronic mass media including broadcast TV[25] and cable TV.[26]

Even if one can make the case that greater concentration and integration would be efficient, public policy might choose not to allow that market structure because it would detract from the more important civic discourse goals of the media. Fortunately, policymakers do not have to confront such a dilemma because the current concentrated market structure is neither efficient nor does it promote diversity. Cable operators are abusing their market power.

C. Measuring Harm

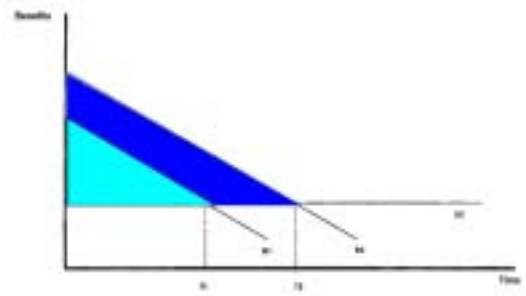
1. Wealth Transfers and Inefficiency

The primary measure of harm flowing from the analysis of market power is the ability to set prices above costs. As noted above, even when firms exercise their market power, they leave some consumer surplus in the consumer's pocket, but they charge more than they would in a competitive market and extract more consumer surplus than they deserve. As mentioned in the introduction, the consumer surplus left on the table is what the cable companies focus on (see Exhibit II-2a). Consumer surplus (or consumer benefits as the paper calls them) is measured as the difference between the value of a service to the consumer (as indicated by the demand curve) and the price the consumer pays for the service. If the value exceeds the price, the consumer buys the product. [27]

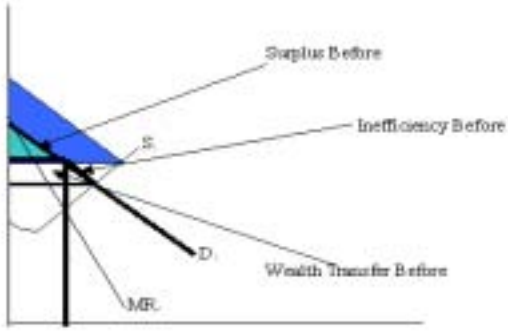
Exhibit II-2b places the consumer surplus analysis in the framework of the complete picture of cable pricing[28] as a classic diagram of the exercise of market power over price.[29] It is well known in economics that the monopolist sets his price at the point where marginal revenue equals marginal cost. The monopolists have captured part of the consumer surplus

Exhibit II-2: Market Power, Consumer Surplus and Deadweight Inefficiency

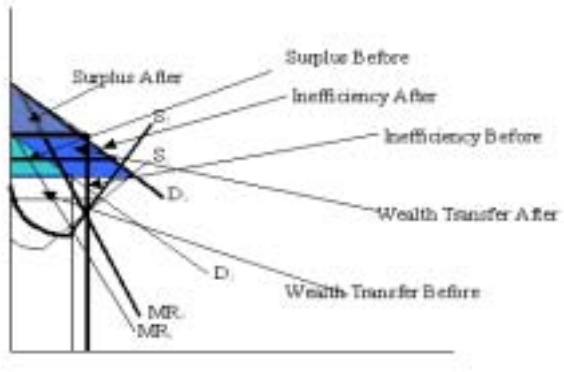
a) NCTA'S Simplistic Analysis



b) Consumer surplus is the tip of the market power iceberg



c) Change in supply and demand with market power persisting



and transferred it to their pockets (wealth transfers). Also, there are some who give up cable or do not take it, when they would have if the price had been at a competitive level. Their loss is a deadweight efficiency loss.

The monopolist can do various things to increase his profits when he hits the profit-maximizing price (see Exhibit II-2c).[30] He can stimulate demand by adding value or by bundling. He can shift the supply curve by lowering his cost or changing his cost structure (and pocket an extra share of the cost savings because he does not face competition). Either or both of these may appear to be welfare enhancing because the quantity consumed increases, but the abuse actually may be increasing on a relative basis because more consumer surplus is being extracted.[31] The relative size of the effects depends on the specific supply and demand curves. This is an empirical question. As depicted in Exhibit II-2c, this paper demonstrates that both the total profit and the rate of profit on traditional video services have increased. Abuse is growing.

2. Monopsony Power

The discussion of antitrust is almost always framed in terms of monopoly power – or the lack of sufficient competition to discipline sellers resulting in their ability to set prices above costs in a market. A similar concern exists with monopsony power.

Monopsony is a situation in which a buyer constitutes such a large part of the market that he or she can dictate prices to sellers. Sellers must bow to the demands of the large buyers because they do not have alternative places to sell their products.

> The mirror image of monopoly is "monopsony." A monopsonist is a monopoly buyer rather than seller. Although most antitrust litigation of market power offenses has involved monopoly sellers rather than buyers, monopsony can impose social costs on society similar to those caused by monopoly.
>
> Monopsony is often thought of as the flip side of monopoly. A monopolist is a seller with no rivals; a monopsonist is a buyer with no rivals. A monopolist has power over price exercised by limiting output. A monopsonist also has power over price, but this power is exercised by limiting aggregate purchases. [32]

Abuse of monopsony power presents a problem because it "injures efficient allocation by reducing the quantity of the input product or service below the efficient level." [33] For the media, loss of efficiency is only part of the problem, since diversity may be sacrificed as well.

This is particularly important in the discussion of the cable industry because cable companies buy programming to distribute to the public.

> Monopsony is thought to be more likely when there are buyers of specialized products or services. For example, a sports league may exercise monopsony (or oligopsony) power in purchasing the services of professional athletes. An owner of a chain of movie theaters, some of which are the sole theaters in small towns, may have monopsony power in the purchase or lease of movies. Cable TV franchises may exercise monopsony power in purchasing television channels that will be offered to their subscribers.[34]

3. Vertical Problems

The previous discussion focuses on the horizontal marker power of cable operators as sellers of video services and buyers of programming. Vertical integration can raise concerns when sellers vertically integrate into programming, especially when dominant firms become integrated across markets for critical inputs. A number of mergers in the communications and high tech industries between increasingly large owners of communications facilities have elicited vigorous analysis of the potential abuse of vertical market power.[35] Just listing the names conveys a sense of the merger wave – AT&T/TCI/MediaOne/Comcast; AOL/Time Warner/Turner/WB; Fox/DirectTV; Viacom/CBS/UPN; NBC/Vivendi/Universal.

Vertical integration can create barriers to entry. By integrating across stages of production, incumbents may force potential competitors to enter at both stages, making competition much less likely.[36] Vertical mergers can also foreclose input or output markets to competitors.[37] Exclusive and preferential deals for the use of facilities and products compound the problem.[38] Cross-subsidization becomes more readily accomplished.[39] Vertical integration facilitates price squeezes and enhances price discrimination.[40]

Concerns arise that not only will the dominant firm in the industry gain leverage across input and output markets to profitably engage in anti-competitive conduct,[41] but also the dynamic processes in the industry will clearly shift toward cooperation and coordination rather than competition. Beyond collusion,[42] a mutual forbearance and reciprocity occurs as spheres of influence are recognized and honored between and among the small number of interrelated entities in the industry.[43] The final behavioral effect is to trigger a rush to integrate and concentrate. Being a small independent firm at any stage renders a company extremely vulnerable to a variety of attacks.[44]

The vertical problem is readily identifiable in the market for video programming. A small number of firms that control distribution are integrated into the production of programming. As a smaller number of owners controls a larger share of the market, they gain greater and greater leverage in the bargaining with independent producers. Indeed, they can make or break programming.

The outlet owners choose more and more to produce their own content rather than buy it from independent producers. As the number of program producers declines, the public interest in diversity and localism is undermined as competition between sources is reduced and the range of programming shrinks. Independent sources that could stimulate greater innovation and creativity, more locally oriented content and more vigorous criticism are diminished. The barrier to entry into the media market rises, since a separate market for independent programming would facilitate entry at one stage of production (programming or distribution) rather than two (vertically integrated programming and distribution).

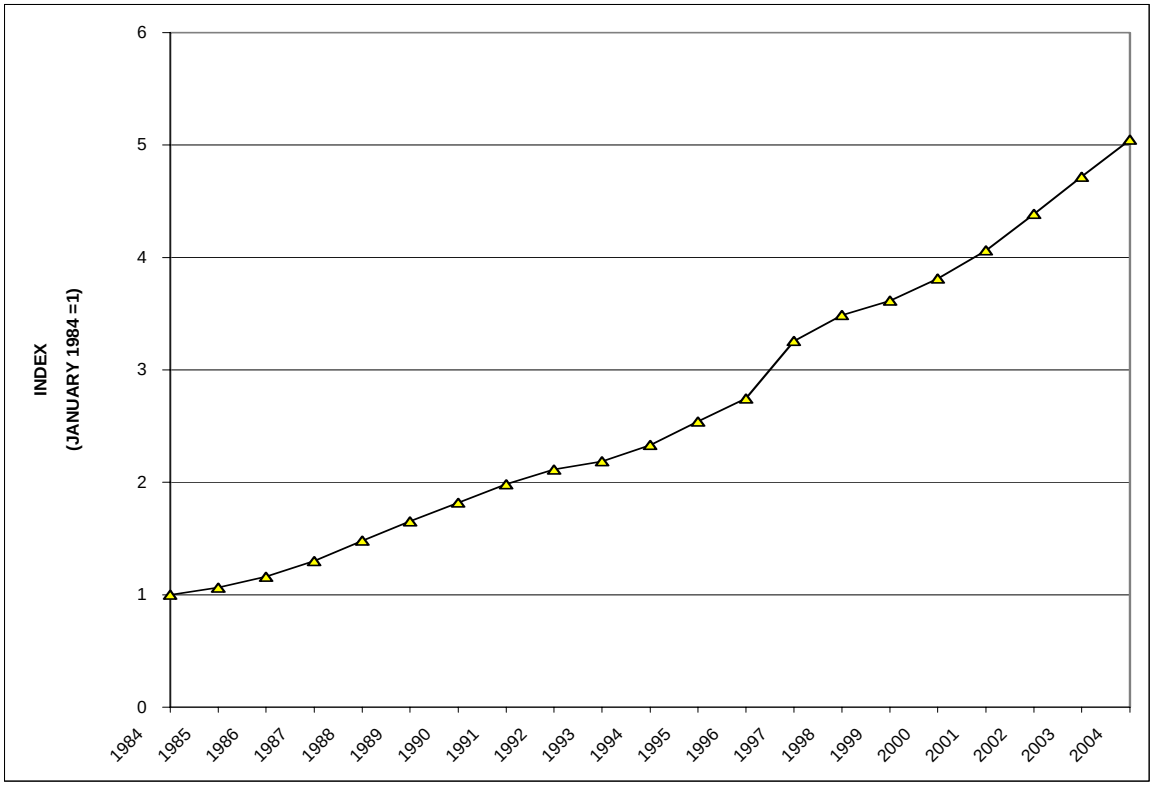
III. CABLE MARKET POWER

A. PERSISTENT MONOPOLY

The cable industry was born in the 1970s with franchise monopoly service territories subject to local regulation. The Cable Act of 1984 gave the FCC the authority to deregulate prices in competitive cable TV markets and restricted the ability of local franchise authorities to oversee the industry. Congress had been told that competition between cable companies would grow as new cable operators overbuilt incumbents and competing technologies would add further competition.[45] The FCC determined that three over-the-air channels were enough to establish effective competition with cable in each community. As a result, cable systems serving about 80 percent of the country were deregulated.

Effective competition failed to materialize either from the entry of additional cable companies into the local franchise area or from other technologies. Over-the-air broadcast signals were extremely feeble competition for cable. Numerous examples of discrimination in programming came to light.[46] Cable prices exploded and public outcry ensued (See Exhibit III-1). In the eight years between cable deregulation (1984) and reregulation (1992), the price

Exhibit III-1: Basic+Expanded Bundle Prices



Sources: Kagan Associates, *History of Cable TV Subscribers and Revenues;* Federal Communications Commission, *Report on Cable Prices*, various issues.

of the basic/expanded basic bundle doubled. Since the passage of the 1996 Act, it has doubled again. Since 1984, the bundle has increased at over five times the rate of inflation.

In an effort to stave off legislation to re-regulate cable,in the late 1980s the FCC reconsidered its three over-the-air rule and switched to six over-the-air stations as a standard. However, the pricing abuse was too great and the FCC's standard too weak to convince Congress that cable's market power would be checked. By 1992, Congress had observed a continuing monopoly at the point –of sale, with increasing concentration at the national level and growing vertical integration between programming and distribution. Congress re-regulated cable rates in 1992 and placed a range of "procompetitive" conditions on the industry, including requirements that the FCC develop a structural limit on ownership (a horizontal limit or cap), rules to ensure access to programming for competing distribution systems, etc.

When Congress revisited the structure of the multichannel video market in the Telecommunications Act of 1996, it decided to relax rate regulation in anticipation of growing transmission competition from satellite and telephone companies. It cautiously left the ban on cross-ownership and the requirement for a horizontal limit in place Congressional caution in the 1996 Act was well grounded, but its optimism about the development of competition for cable was totally inappropriate.

Overbuilding is moribund.[47] One of the great disappointments of the 1996 Telecommunications Act has been the failure of competition from alternative technologies to break down the market power of the incumbents.[48] Congress devoted a whole section of the law to telephone competition for cable through open video systems.[49] Today, open video systems are non-existent.[50] As discussed below, cross-technology competition from satellite is weak as well. This track record teaches us that we should be very skeptical of promises about future technologies that are "just around the corner," which will break the grip of the cable monopoly.

Unfortunately, when Congress decided to move media and communications policy toward greater reliance on competition in the Telecommunications Act of 1996, the cable operators headed in the opposite direction. Rather than use their expertise, existing plant and ownership of programming to enter neighboring service territories, the dominant cable companies chose to buy each other instead. Not one major incumbent has ever sought to overbuild a neighbor to compete against another incumbent. The monopolies they had gained through franchise awards in the 1970s and defended through anticompetitive behavior in the 1980s were merged into ever-larger systems and clusters in the 1990s. The result has been a dramatic increase in concentration and clustering of systems.

Thus, we should not be surprised to find that in the late 1990s, the Assistant U.S. Attorney General for Antitrust called the cable industry "the most persistent monopoly in the American economy."[51] Since that statement was made, mergers have been executed between the first, third and fourth largest companies, creating a single giant that towers over the

industry, almost twice as large as the second largest cable operator. Regional markets have been drawn into huge clusters of systems. Broadcast and cable programmers have merged. Broadcast and satellite distributors have merged.

In the same period, the cable industry has also seized a dominant position in high-speed Internet access service, with an 85 percent market share for advanced, high-speed Internet access in the residential sector.[52] It has extended its anticompetitive and anti-consumer practices to this critical new market for advanced telecommunications.[53]

The vast majority of the costs of the upgrade for digital TV and high-speed Internet are common between the two services. Cable has gained as many digital TV subscribers as satellite in half the time. Cable companies have tied basic cable and high-speed Internet to exercise leverage against satellite services, which cannot easily match the bundle. Claims that competition from alternative technologies is sufficient to discipline cable in either the video distribution or high-speed Internet access market are not supported by the available econometric evidence or consumers' real world experience. By every measure of market power typically used in economic analysis, cable operators have it and are abusing it.

B. Market Structure

1. Local MVPD Market Concentration

Head-to-head competition between cable companies is virtually non-existent. Out of 3000 plus cable systems, head-to-head competition exists in fewer than 200, although another 150 have certified entry. In short, only about 1 percent of franchise territories have experienced head-to-head competition between cable companies. The failure of competition in multichannel video is most evident in local markets. Although overbuilders target larger urban areas, only one cable company serves over 98 percent of the homes passed in the country.[54] While a number of other communities have authorized additional overbuilding, this activity is slowing, as the regional Bell Operating Companies pull back and pure overbuilders retrench.[55] The nation's largest overbuilder recently declared bankruptcy.

Cable's dominance as the multichannel medium is overwhelming, with a subscribership of approximately two-thirds of all TV households. Its penetration is about three times as high as the next multichannel technology, satellite. Because a large number of satellite subscribers live in areas that are not served by cable, competition in geographic markets is less vigorous than the national totals suggest. Cable has about four times the market share of satellite in markets where both are available.

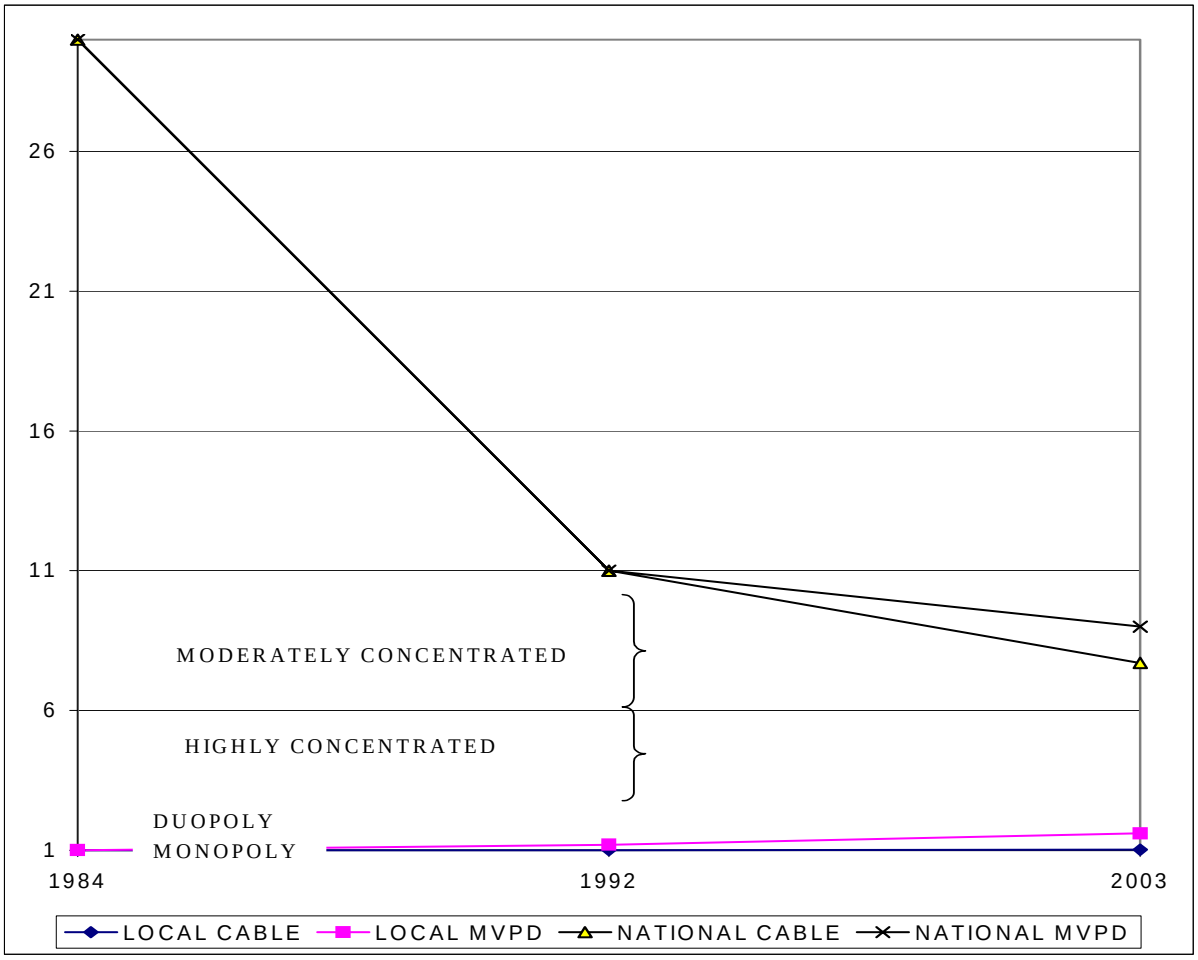
This market power at the point of sale is reinforced by a strong trend toward regionalization in which one company gains ownership of many firms in a region. Clustering has increased sharply since 1994, up by almost 75 percent.[56] Just over one-half of all cable subscribers were clustered in 1997, but by 2002 three-quarters were.[57]

This suggests that cable retains a market share at the point of sale of above 80 percent.[58] The HHI index at the local level is above 6400, at best a duopoly (see Exhibit III-2).[59]

2. National MVPD Market Concentration

The wave of industry concentration after deregulation is striking at the national level. When cable was deregulated in 1984, the distribution segment was not concentrated at all (HHI about 350), with the equivalent of just under30 equal-sized competitors. A decade later, concentration had advanced to the point where the distribution segment had the equivalent of about 11 equal-sized competitors (HHI about 930). This is close to the moderately concentrated threshold. In the past decade, industry mergers have increased concentration into

Exhibit III-2: Cable Competition
(Expressed as Equivalent of Equal Sized Voice)



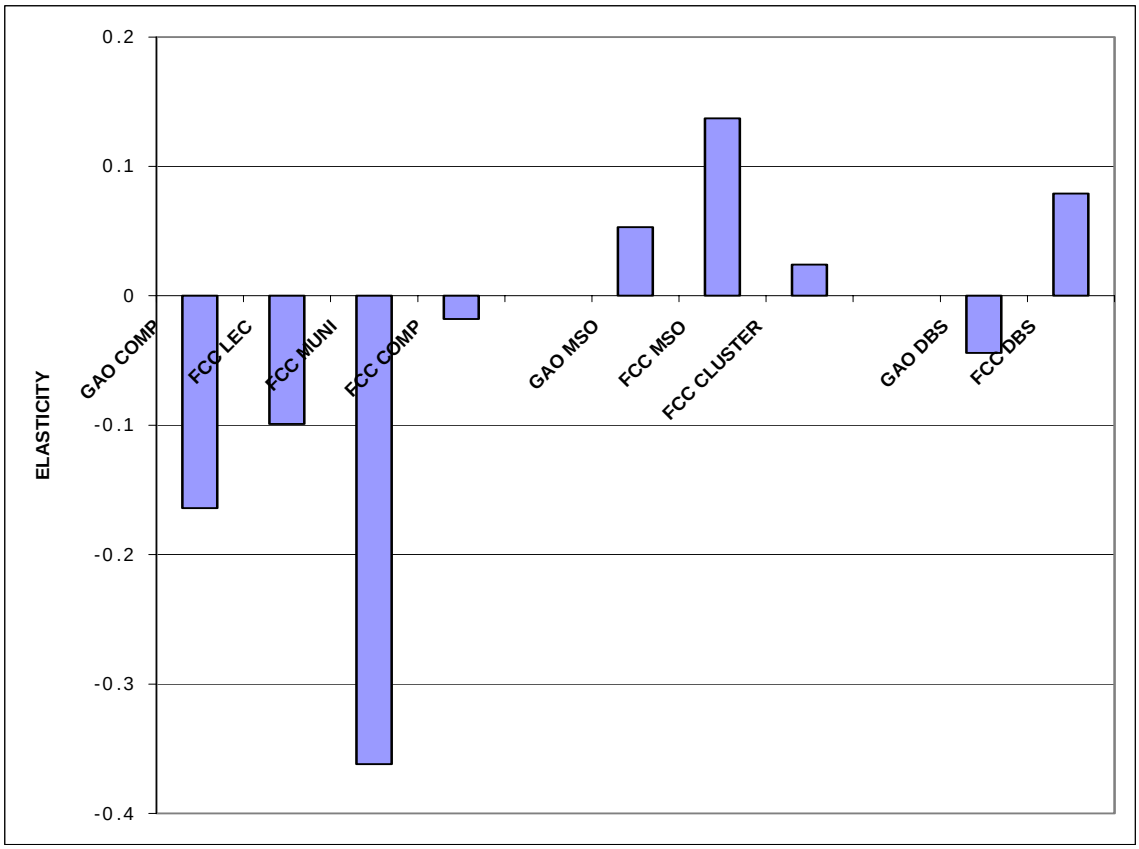
Sources: Federal Communications Commission, *Annual Report on Cable Competition*, various issues.

the moderately concentrated range. The FCC indicates an HHI of just over 1,000 largely because it has expanded its definition to include satellite. However, as we show below, satellite is at best a partial competitor. Concentration calculated for cable only puts the HHI at just under 1,300, fewer than eight equal-sized competitors. The effective concentration for multichannel video falls between 1,000 and 1,300. Thus, the national market has been reduced to the equivalent of about nine equal-sized competitors.

C. Econometric Evidence on Market Power

The structural conditions indicate that cable operators are likely to possess market power. Econometric evidence indicates that they exercise it. A recent General Accounting Office (GAO) report affirms each of the supply-side problems of the multichannel video market that has afflicted the American public since the industry was prematurely deregulated in 1984 and further deregulated in 1996. Exhibit III-3 shows elasticities for various market structural characteristics that affect the extent of competition, which are included in the

Exhibit III-3: Impact Of Market Structure Characteristics On Monthly Rates (Regression Coefficients, dummy variables)



Sources: Federal Communications Commission, *Report on Cable Prices,* April 4, 2002, Attachment D-1; General Accounting Office, *Issues Related to Competition and Subscriber Rates in the Cable Television Industry,* October 2003, Appendix IV, Table 3.

regression analyses conducted by the GAO and the FCC. They contradict the claims that cable faces effective competition and lacks market power.

Head-to-head, wireline competition is the only market structure feature that significantly disciplines monopolistic pricing. In its most recent report, the GAO finds that head-to-head, wireline competition between cable operators lowers prices by 15 percent for basic and expanded basic service.[60] Its earlier report had found a 17 percent difference.[61] Ironically, the FCC's *Tenth Annual Report (In the Matter of Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming)* notes that head-to-head competition lowered prices by 16 percent.[62] Recent FCC econometric models, which identified three types of head-to-head competitors (local exchange carriers [LECs], publicly owned systems [munis] and other private overbuilders [comp]), have consistently found large price effects from head-to-head, wireline competition.[63] Unfortunately, as noted, less than 2 percent of American households enjoy the benefit of head-to-head, wireline competition.[64] The result is an abuse of market power that costs the American public about $4.5 billion per year in cable rates alone.[65]

Bigger monopolies are worse when it comes to consumer prices. In the GAO analysis, if a cable system is part of a large national operator, its prices are 5.4 percent higher than if it is not.[66] (The GAO called this horizontal concentration.) FCC econometric models have been finding this to be the case for several years, with even larger effects of being part of a multiple system operator (MSO).[67] When the FCC models add in a specific variable for regional clustering, a dramatic trend in the industry, they find that clustering has an added effect of further raising price.[68] The ownership of multiple systems by a single entity, large size and clustering of cable systems result in higher prices.[69] Being served by one of the mega-multiple system operators who have been expanding their grip on the industry through mergers and clustering drives prices higher by more than 5 percent and perhaps as much as 8 percent. Thus, there could be as much as an additional $1.5 billion in consumer savings that could be wrung out of the cable market if it were deconcentrated.

The elasticity of demand is low. The First Annual Report on competition in the video market observed that the elasticity of demand is another indicator of the level of competition in the market. "The nature of demand for any product or service is an important basic condition affecting market structure. In particular, the degree of consumer price sensitivity or own-price elasticity of demand is an indicator of the availability of competing substitute products or services."[70]

The FCC's econometric studies concluded that the **"the demand for cable service is somewhat price elastic (i.e. has a price elasticity of minus 1.45) and suggests that there are substitutes for cable."**[71] This elasticity is not very large and the Commission recognizes that in using the adjective "somewhat." The recent GAO report found a similar elasticity of demand.[72] In traditional analyses of market power, an elasticity of demand at this level combined with the market shares for cable in the multchannel video market is a strong indication that cable operators have market power.[73]

The important implication is that the theory used to allow large cable operators to become larger in recent years is not supported by the empirical evidence.[74] That theory claimed that the combination of larger, clustered systems would create efficiency-based cost savings that would be passed on to the public because one big monopolist is no worse than two, contiguous smaller ones. Since large incumbents never overbuild one another to compete, the theory claimed there was little to be lost. The econometric evidence suggests that there is considerable harm. It turns out that large operators and clustered systems have more muscle to thwart competition and impose price increases. They can distribute programming terrestrially and extract exclusivity deals from independent programmers, thereby denying programming to competing distribution media (overbuilders and satellite). They have more leverage over local governments to obstruct the entry of overbuilders. Policymakers surrendered to the cable urge to merge too easily. If cable operators knew they could not grow through mergers, and they really cared about size so much, they might compete by overbuilding one another.[75]

Exhibit III-4 explores the implications of the most recent econometric findings on horizontal market power. Using the traditional measure of market power and the standard measure of the pricing abuse that results – the Lerner index – it explores the relationship between the number and size of firms in cable markets and the mark-up of price over cost. The mark-up of price above cost is inversely related to the extent of competition and the market elasticity of demand. The more competitive the market and the more elastic the demand, the less the ability to increase price. The analysis uses the econometric estimate of the elasticity of demand and the implicit HHI. The econometric estimate of a 20 percent mark-up from a lack of head-to-head competition and horizontal concentration is consistent with, even a conservative estimate of, the pricing power suggested by the market structural conditions (demand elasticity and market shares) implicit in both the GAO and the FCC analyses.

D. The Failure of Cross Technology Competition

Intermodal competition – between cable and satellite – does not effectively discipline cable's pricing power. In contrast to head-to-head, wireline competition, which lowers cable bills by $5 per month, competition from direct broadcast satellite (DBS) lowers bills by a mere $.15, according to the GAO.[76] In other words, head-to-head, wireline competition is almost 40 times as effective as intermodal competition when it comes to price. In fact, in the GAO report, even satellite's very modest pricing effect is not statistically significant by traditional standards. It fails at the 5 percent level of significance. The FCC's econometric analysis does not find even this small price effect. It finds a statistically significant effect in the opposite direction.[77]

To the extent that satellite has any competitive effect, it drives cable operators to offer more channels, but this effect stems from the decision of satellite to offer local programming. Where satellite offers local programming, cable operators offer about 5.4 percent more cable

Exhibit III-4: Comparison of Empirical Estimates of Mark-Up Using Alternative Measures of Concentration and Dummy Variables

SOURCE	CONCENTRATION MEASURES		
	Non-competitive	Competitive	
FCC (E_d = 2.2)	HHI = 6800	HHI = 3912	$\triangle$ L
	45.1	17.8	-27.3
DIRECT ESTIMATE			
Head-To-Head			- 9.1
Concentration			-25.6
Total			-34.1
GAO (E_d = 1.54)	HHI = 7312	HHI = 3418	
	47.4	22.2	-27.3
DIRECT ESTIMATE			
Head-To-Head			-15.1
Concentration			- 5.4
Total			-20.5

Sources: Federal Communications Commission, *Report on Cable Prices,* April 4, 2002, Attachment D-1; U.S. General Accounting Office, *Issues Related to Competition and Subscriber Rates in the Cable Television Industry,* October 2003, Appendix IV, Table 3. Viscusi, W. Kip, John M. Vernon and Joseph E. Harrington, Jr., *Economics of Regulation and Antitrust* (Cambridge, MA: MIT Press, 2001), pp. 102-108, 147-149, 258-259. Lerner Index:

$$L = S_i \frac{(P_m - MC)}{P_m} = \frac{HHI}{10000} * \frac{1}{E_d}$$

channels. Thus, satellite appears as a niche product that cannot discipline cable pricing abuse for the vast majority of cable subscribers who take only basic and expanded basic.[78]

Unfortunately, because of its cost and other characteristics, satellite has fallen far short of providing widespread and vigorous competition. The FCC's own analysis shows and has consistently shown that satellite does not now, nor has it ever, exerted a significant and substantial competitive effect on cable industry price. Its effect on the bundling practices of cable will be especially muted because the niche where it competes with cable is a high volume, high quality segment of the market. It sells even bigger bundles than cable and, therefore, can exert little pressure on cable to break apart the bundle.

Claims that cable "faces intense competition from DBS providers"[79] do not stand close scrutiny. If satellite were a close substitute for cable, one would expect that it would have a large effect on cable. In fact, the FCC's own findings and data have contradicted the cable industry claims for years. The Commission never stated that cable and satellite are close

substitutes. It found, at best, that satellite only "**exerts a small (shown by the small magnitude of DBS coefficient) but statistically significant influence on the demand for cable service."**[80] Even the finding of a small effect has recently been reversed.

The FCC also attempted to estimate a price effect between satellite and cable. If cable and satellite were close substitutes providing stiff competition, one would also expect to see a price effect. Most discussions in economics textbooks state that substitutes exhibit a positive cross-price elasticity.[81] The FCC can find none. In fact, it found quite the opposite. The higher the penetration of satellite, the higher the price of cable.[82]

The most recent annual report on cable prices shows that the presence of DBS has no statistically significant or substantial effect on cable prices, penetration or quality.[83] This is true when measured as the level of penetration of satellite across all cable systems, or when isolating only areas where satellite has achieved a relatively high penetration.[84]

1. Satellite's Initial Success Came in Entering New, Niche Markets, It Did Not Compete for Cable's Existing Markets

With feeble support for the claim of competition in the econometric evidence, it is not surprising that cable industry analyses are forced to misinterpret subscriber patterns to maintain a consistent, but incorrect, story.[85] This simplistic analysis is wrong and does not stand close scrutiny.

Cable's subscriber base continued to grow at a steady pace throughout the recent period of rapid satellite growth. Without careful analysis, cable industry experts incorrectly assume the growth of satellite has come entirely at the expense of cable. The cable industry experts have ignored new markets. The industry and the FCC have confused separate geographic markets and product market segments served by different technologies with intermodal competition.

In fact, satellite drew its subscribers from two places that cable had not gone. A very substantial segment of the satellite market exists in places not served by cable. Moreover, satellite was the only digital service available for a considerable period of time. In other words, cable was not losing subscribers to satellite, satellite was expanding the market. There is no reason to believe that, during this time period, cable could have entered those markets with an economically attractive offering. Because a very substantial part of satellite growth did not "come at the expense of cable," it did not discipline the market behavior of cable. In fact, while satellite was growing fastest, cable continued to grow at close to its historic rates. In this sense, it did not compete in the market with cable; it served markets that were adjacent to the cable market. The implications of this analysis for public policy are important and straightforward. Satellite has always been a digital niche player. It never competed for the bulk of cable's basic/expanded basic customer base.[86]

Cable's offering of digital service is growing much faster than satellite's comparable service. The addition of high-capacity digital cable and cable modem Internet services allows

cable operators to attack the high-end niche that satellite occupies.[87] Cable will be able to leapfrog satellite at the high-end of the market, particularly when it is bundled with high-speed Internet access.[88]

2. Survey Results Show That Cable-Satellite Competitive Overlap is Small

The previous two sections demonstrated the inability of satellite to discipline cable with quantitative data on pricing and product substitution. As suggested above, this data "indicate that DBS is not a particularly good substitute for cable in the minds of consumers." This section examines survey data to gain another perspective on "the minds of consumers." Recognizing geographic and product market differences we reinforce the conclusion that the competitive overlap between DBS and cable is low and satellite cannot break the cable bundle.

A substantial number of satellite subscribers live in areas where cable is not available.[89] A second group of customers – 2 to 2.5 million people who take both satellite and cable – represents a geographic market problem for satellite.[90] For these customers, cable and satellite would appear to be complements rather than substitutes. One reason to take both services is that local programming is more limited from satellite. Satellite subscribers who also take cable have a lower cable bill than other cable subscribers. They are almost three times as likely to report that their cable bill is less than $30 per month (46 percent to 17 percent), suggesting that they take the basic tier which gives them the local channels they cannot get with satellite. They also report watching many fewer channels than other satellite and cable subscribers. Satellite may overcome this handicap in some markets, depending on available capacity to transmit local channels.

The subset of consumers who take satellite in competitive markets and do not subscribe to cable does so because satellite is perceived as a high volume, higher quality service. Three-quarters of these satellite subscribers said they chose it because of the number of channels.

Given the attraction of satellite's wide selection, we should not be surprised to find that satellite subscribers have very different viewing patterns than analog cable subscribers. Competitive market, satellite-only subscribers are less likely to watch broadcast networks and local public access channels (which they probably cannot get). Even the satellite subscribers who also get cable are less likely to watch local public access channels. Competitive market, satellite-only subscribers are more likely to watch premium movie, sports and pay per view channels than those who get cable and satellite or just analog. However, digital cable subscribers look more like satellite-only subscribers than analog cable subscribers in their purchases of premium movies, sports and pay-per view.

Examination of the data reveals that the cable analog group has a clearly identified subgroup that we call the "lunch bucket," cable group. Eighty percent of the cable analog group subscribes to only basic and expanded basic service and takes no additional tiers. This

represents the largest segment of cable subscribers by far. The remainder of the analog cable group is more upscale, subscribing to, on average, a total of 4 tiers. In contrast, three-quarters of satellite subscribers take pay tiers.

The cable strategy for responding to satellite is to exploit market power in the lunch bucket segment by driving up prices much faster than inflation. Viewers with less expensive tiers of cable programming are insensitive to rate increases because DBS only competes with cable for multiple pay-service tier subscribers (those who buy expensive sports and movie packages). Furthermore, cable MSOs are able to extract monopoly rents from the lower tier subscribers to cross-subsidize their competition with DBS for mega-service subscribers. It makes better economic sense for cable operators to increase prices than to hold them down. Cable makes much more money by increasing prices for basic cable than competing in the DBS niche. The revenue gained by increasing cable prices to existing subscribers since the Telecom Act of 1996 exceeds the revenue lost to all DBS-only subscribers by almost two to one and all DBS-only subscribers in areas where cable is available by three to one. Cable revenues added from new subscribers, at the higher prices, just about equaled cable revenues lost to new DBS-only subscribers in areas where cable is available.[91] Thus, there is little chance that satellite will push cable to abandon forced bundling.

The failure of satellite to discipline pricing should come as no surprise. Even in the midst of the debate over delivery of local stations by satellite, the largest satellite provider eschewed price competition for the basic package.[92] The same was true on the cable side, where "anecdotal evidence shows that the response by large cable operators to increased DBS competition often includes the offering of new services such as digital tiers and Internet access, rather than by lowering monthly charges."[93]

IV. DISCRIMINATION AND ANTICOMPETITIVE PRACTICES OF CABLE OPERATORS IN VIDEO PROGRAMMING MARKETS

By forcing consumers to take large bundles and controlling the content of the bundles, cable operators control the flow of content and the access of programmers to the public. By leveraging their control of distribution, they ensure favorable treatment for their own shows.

A. The Cable Fairy Tale: The Dance of the Enlightened Elephants

The cable industry and its experts argue that discrimination and anticompetitive conduct by cable operators as buyers in the programming market simply cannot and does not happen.[94] However, two decades of evidence from the deregulated cable industry, demonstrates that "It does happen on a regular basis."

Cable experts argue that monopsony power does not matter in the cable TV industry because of the nature of the product — i.e., video programming is a highly differentiated product with high first copy costs.[95] If products are very different from each other, the cable experts argue, they possess attributes that distinguish them in the mind of the consumer, which enables the programmers who own popular content to withhold their products and force multiple system operators (MSOs) to enter fair and efficient deals.[96] Even where the cable operators might have market power, the cable experts claim, cable operators realize that they share a strong interest with programmers to ensure the flow of quality programming, so they treat programmers fairly.

In order to make this analysis plausible, cable industry experts must assume away key facts about the cable market. The picture that they paint bear no relationship to reality. They assume no ability to price discriminate,[97] no market power for the buyers,[98] a lack of specialized inputs,[99] fair competition for the sellers[100] and highly differentiated products.[101] With the most challenging problems assumed away, the cable company experts have reduced the entire analysis to a battle over rents between cable operators and programmers, which they assume can have no basis in public policy.[102]

In order to put a reasonable face on the "bargaining" that results, the cable experts must assume what is essentially a marketplace of huge and powerful programmers, some of whom are vertically integrated, facing off against huge and powerful MSOs, some of whom are integrated.[103] In addition to being vertically integrated, other strategies that might help programmers survive are to have large portfolios of programs[104] or sell in foreign markets.[105]

The dance of the elephants tramples the mice (independent producers) and the grass (consumers). There is little room for independent, modestly sized, domestic producers of programming in this dance. Therefore, in the hypothetical cable world, small independent entities depend on the enlightened self-interest of the cable operators to protect them. They

need not fear in this fantasy world because cable operators behave well. Indeed, the bigger the cable operator, the better they treat the small independent producers because they have too much to lose.[106]

B. Evidence of Discrimination

Do the assumptions underlying the theory properly reflect economic reality? Tthe answer is no. Cable operators discriminate and use other anticompetitive practices by leveraging their control of distribution to defend their franchise product. Evidence of these problems is both qualitative and quantitative and it comes from both integrated and nonintegrated entities.[107]

1. Econometric Studies

Vertical relationships are exploited by cable operators. GAO finds that cable operators are majority owners of one-fifth of the top 90 national networks. The GAO does not find price discrimination but it does find discrimination in carriage. That is, cable operators do not charge more for their own shows, but they are much more likely to air them. The effect is quite large. Cable operators are 64 percent more likely to carry the programming in which they have a majority ownership stake. Cable operators who have a stake in programming also carry fewer channels overall. This result is consistent with prior academic studies.[108]

A one-fifth share of the most popular programs is a very substantial stake in the programming market and it blunts cable operators' incentive to resist price increases. Cable operators own minority stakes in other networks, as well. With their market power at the point-of-sale, cable operators know that they can pass costs through to consumers and they can assure that their own programs are carried much more frequently than those of others, thereby gaining a disproportionate share of the overall increase in programming costs.

While no cable operator had pricing power in the programming market until recently, Comcast, with its AT&T cable acquisition, appears to have gained pricing power as a large purchaser of programming. Having achieved a large enough market share, it now has monopsony power over sellers of programming. Comcast is squeezing programmers to lower their fees at the same time it is announcing price increases for basic and expanded basic. It is both reallocating rents from programmers to itself [109] and increasing the rents collected from consumers.[110]

Rights of carriage matter a great deal in the cable industry. The decision of Congress to give broadcasters must carry/retransmission rights has enabled broadcasters to gain a significant advantage for their programming, in terms of carriage. Programs owned by broadcasters are 41 percent more likely to be carried by cable operators. Clearly, independent programmers are at a severe disadvantage, as has been demonstrated time and again. Although the GAO report concludes that 38% of the cable networks are majority owned by

non-cable, non-broadcast firms, a much smaller percentage, less than 20 percent, do not have at least some minority ownership of broadcasters or cable operators.

One of the keys to proper analysis of discrimination is to pay careful attention to the actual reason for discrimination – i.e. the analyst must differentiate between programs within specific categories. The issue of product differentiation discussed above is more complex than the cable theorists admit. Different categories of programming – such as news versus entertainment – are clearly differentiated. There is also an effort to create differentiation within program categories through branding. Hit comedies are distinct and the producers of such programs may have bargaining power. At the same time, there is a process of rivalrous imitation in the industry.[111]

When such a view is taken, discrimination is apparent.

> Operators who own premium cable services offer, on average, one fewer premium service than do other operators. In particular, operators who own premium movie services are less likely to carry the rival basic movie service, American Movie Classics (AMC). In addition, TCI and Comcast, two operators who own the basic shopping service, QVC, are less likely to carry both QVC and HSN. These results are statistically significant and establish that premium operators and certain basic operators are less likely to carry rival services.[112]
>
> While differences are often insignificant or minor, a consistent general pattern emerges: Integrated cable systems tend to "favor" the programming with which they have ownership ties, either by carrying those networks more frequently than would otherwise be expected or by pricing them lower or marketing them more vigorously. Our analysis also shows that integrated systems tend to disadvantage unaffiliated networks in those same respects, at least if the latter are good substitutes for affiliated programming. Integrated systems also tend to offer fewer cable networks in total, although the differences are very small. The dominant effect appears to be that integrated cable systems replace unaffiliated networks with similar, affiliated networks. A separate analysis of the effects of vertical integration on larger channel capacity systems suggests that those effects of integration will persist, though they will diminish, as channel capacities expand or VOD [video on demand] systems are developed.[113]

It is also important to recognize that complete foreclosure is not the only concern. The terms and conditions of carriage are at least as important. Vertically integrated firms defend the marquis programming in which they have a direct interest by frustrating entry and extract rents from others.

> The power to foreclose also implies the ability to force down the license fees that an MSO pays to networks. Some anecdotal evidence suggests the

> possibility that larger MSOs hold significant monopsony power in the programming market.[114]
>
> Carriage data provide an incomplete picture of vertical integration's effects on premium networks. In particular, even if both affiliated and unaffiliated networks are carried, an integrated system might price them differently to subscribers. Personal selling and other marketing tactics offer other opportunities for system operators to favor one available network over another… For the most part, those subscribership results suggest that integrated systems also tend to favor their affiliated premium networks in pricing and promotion behavior.[115]

This published analysis is quite strong on the foreclosure finding. It provides a detailed understanding of foreclosure motivations and behaviors. Integrated owners of basic programming, exclude competitors for their basic package but offer more of their own basic packages and more premium packages.[116]

Owners of premium services foreclose competitors and sell more of their own, but offer fewer services at higher prices.[117] While the published research on foreclosure to which the Commission points is strong on finding foreclosure, it is weak on the consumer welfare impact of vertical foreclosure.[118] At best, the result for basic services is more variety, but less diversity of ownership.[119] The change in welfare is positive (because of more subscribers) but not statistically significant[120] The leading study in the field, Waterman and Weiss, finds that horizontal market power is the central concern.[121]

2. Qualitative Evidence

The most dramatic demonstration that the theory and explanations offered by cable have lost touch with reality can be found in the claim that programmers seek to have MSOs take an equity stake in their shows or desire exclusive arrangements to lower their risks or increase their profits.[122] The stumbling block for programmers is not raising capital or assembling talent to create shows. The only thing they lack is carriage.[123] Programmers do not ask MSOs to take equity stakes or seek benefits in deals that prevent them from making their shows available to all means of distribution; MSOs extort equity or exclusive arrangements from programmers by withholding carriage. The MSOs control the programming market and undermine competing distribution systems with their anticompetitive and discriminatory practices.

Occasionally, practices within the industry became so bad that collegiality breaks down and even major players became involved in formal protests. Viacom and its affiliates, a group not interconnected significantly with the top two cabals in the industry, filed an antitrust lawsuit against the largest chain of affiliated competitors in its New York territory.[124] Ultimately, it sold its distribution business to its competitors.

The dispute between Yankee Entertainment Sports (YES) and Cablevision is another example.[125] YES alleges and provides facts to support its claim that the refusal to provide nondiscriminatory carriage is part of a scheme to prevent competition in sports programming,[126] and preserve Cablevision's local monopoly in distribution.[127] It documents a long history of threats to foreclose markets as a lever against programmers back to the 1980s.[128] The demands of the operator include demands for equity[129] and exclusivity.[130] "Bargaining" with a dominant distribution incumbent involves take-it-or-leave-it-threats[131] that offers inferior placement,[132] discriminatory prices,[133] or exclusion from carriage. Programmers have little bargaining power,[134] particularly since denial of access to 40 percent of the market renders new programming unviable.[135]

The market structure that conveys the leverage to the distributors is precisely described by YES. There is little direct competition in distribution, with Cablevision having a 90 percent market share,[136] which remains insulated behind barriers to entry.[137] Market power has been acquired and reinforced by acquisition of distribution and programming.[138] Regional market power through clustering plays a critical role[139] particularly for advertising markets.[140] Dominating specific programming categories generates both high profits and provides leverage to undermine competitors.[141] Cable operators have recently added bundling of high speed Internet to their arsenal of anticompetitive practices[142] and reinforced it with anticompetitive contracts.[143]

Other examples of resistance to entry of programming that might compete with the marquee offerings of the vertically integrated incumbent programming abound. These include national[144] and local[145] news programming, home shopping networks,[146] as well as niche programming including educational,[147] arts,[148] and minority[149] programming.

The natural tendency of the industry's largest players to discriminate was documented in the Time Warner/Turner/TCI merger proposal. The FTC rejected the Time Warner/Turner/TCI merger proposal and imposed conditions on it. It rejected a preferential deal for TCI's purchase of Time Warner programming and required TCI to reduce its level of ownership in Time Warner to less than 10 percent of nonvoting stock (i.e., a non-attributable, passive level).[150]

The FTC's enumeration of the ways in which the Time Warner/Turner/TCI merger was a threat to lessen competition are instructive for both the cable TV and the broadband Internet markets. First, with respect to programming, the FTC saw a number of grounds for believing competition would be lessened:

> enabling Respondent Time Warner to increase prices on its Cable Television Programming Services sold to MVPDs, directly or indirectly (e.g., by requiring the purchase of unwanted programming). Through it's increased negotiating leverage with MVPDs, including through purchase of one or more "marquee" or "crown jewel" channels on purchase of other channels.

> enabling Respondent Time Warner to increase prices on its Cable Television Programming Services sold to MVPDs by raising barriers to entry by new competitors or to repositioning by existing competitors, by preventing such rivals from achieving sufficient distribution to realize economies of scale; these effects are likely, because Respondent Time Warner has direct financial incentives as the post-acquisition owner of the Turner Cable Television Programming Services not to carry other Cable Television Programming Services that directly compete with Turner Cable Television Programming Services; and
>
> Respondent TCI has diminished incentives and diminished ability to either carry or invest in Cable Television Programming Services that directly compete with the Turner Cable Television Programming Services because the PSA agreements require TCI to carry Turner's CNN, Headline News, TNT and WTBS for 20 years, and because TCI, as a significant shareholder of Time Warner, will have significant financial incentives to protect all of Time Warner's Cable Television Programming.[151]

The FTC also concluded that the Time Warner/Turner/TCI merger could reduce competition in distribution markets by:

> denying rival MVPDs and any potential rival MVPDs of Respondent Time Warner competitive prices for Cable Television Programming Services, or charging rivals discriminatorily high prices for Cable Television Programming services.[152]

The cable TV programming market has not changed much since the FTC made these observations. If anything, it has gotten much worse, if for no other reason than it has an additional "crown jewel" to leverage against competitors and unaffiliated programmers – high-speed Internet access.

Overbuilders have faced vigorous efforts to prevent competition through exclusion from access to programming and regulatory tactics of incumbent cable operators.[153] Comcast has shifted some sports programming to terrestrial delivery, thereby avoiding the open access requirement of the 1992 statute. As cable operators become larger and more clustered, this strategy will become increasingly attractive to them. Specific areas where such programming has been denied are Phoenix, Kansas, Philadelphia and New York. The denial of access to marquee sports programming can have a devastating effect, with satellite providers in markets where foreclosure has occurred achieving a market penetration only one-quarter of the national average.[154]

Integrated MSOs wield immense power against smaller cable companies, exploiting loopholes in the program access rules.[155] For the smaller entities, the current refusals to deal are not limited to sports programming. Other services have been denied, such as video on demand.[156]

Second, where the large MSOs do not have direct ownership of video services, they have obtained exclusive arrangements, thereby denying competitors and potential competitors access to programming.[157] The exclusionary tactics apply not only to head-to-head cable operators and satellite providers, but also to DSL-based providers seeking to put together a package of voice, video, and data products. Bundling is critical to entry into the emerging digital multimedia market.[158]

Third, because the dominant MSOs are so large, they can influence important programmers not to sell to competitors or potential competitors. As the Commission noted, Ameritech and the WCA found that they were cut off from programming.[159] The list could go on and on.[160]

The problem is not simply one of complete exclusion. Dominant, vertically-integrated MSOs can inflict "discriminatory or excessively burdensome terms and conditions of programming distribution."[161] Recent comments in the program access proceeding point to an even more stark demonstration of the power of cable to engage in content discrimination.[162]

C. Dominance in Programming

The repeated examples of anticompetitive conduct do not comport with the image of a benign, efficiency enhancing monopsonist offered by the cable experts. A second problem with the benign picture painted by the cable industry experts is the fact that a small number of companies dominate the programming side of the multichannel video market and have done so for a decade.

Programmers who have hit shows that are distinctive and well branded may have some bargaining power, but there are very few of them. How new entrants get into that position is unclear, especially when integrated entities can foreclose the market or discriminate against new entrants. There is very little entry by unaffiliated entities and very little churn in the ownership of industry programming.

The pattern of development of programs also contradicts the cable industry's rosy view. We start our analysis with the popular networks, and work down from there. The Commission's annual reports provide a basis for assessing the movement in the most popular program networks (see Exhibit IV-1). To be consistent, we identified the top 20 channels by subscription and the top 15 by prime time ratings in the First and Tenth Annual Reports on Video Competition. These channels account for over one-half of cable's primetime viewers and about one-third of cable's all day viewers. There are 28 networks on the two lists. Of these, 23 are on both lists. Either a cable MSO or a broadcast network has an ownership interest in all but one of them (the Weather Channel). In other words, it appears that you must either own a wire or have transmission rights to be in the top tier of program networks.

The dominance of a few entities is not restricted to the most popular shows that were generally established prior to the passage of the 1992 Act. As Exhibit IV-2 shows, of the 39

Exhibit IV-1: Top Channels, 1992-2003
Exhibit IV-1: Concentration of Ownership of Marquee Programming

CHANNEL	1993 RANK SUBS	1993 RANK PRIME TIME	2003 RANK SUBS	2003 RANK PRIME TIME	OWNER
ESPN	1	4	2	14	ABC/DISNEY
CNN	2	12	6	7	AOLTW
USA	3	1	5	4	LIBERTY
NICK	4	6	8	10	CBS/VIACOM
DISCOVERY	5	10	4	1	LIBERTY
TBS	6	2	1	5	AOLTW
TNT	7	3	6	3	AOLTW
CSPAN	8		3		CABLE
					CONSORTIUM
MTV	9	13	13	11	CBS/VIACOM
LIFETIME	10	7	8	12	ABC/DISNEY
TNN	11	11	11	13	CBS/VIACOM
FAMILY	12	8	15		ABC/DISNEY
A&E	13	9	130	8	ABC/DISNEY
WEATHER	14		14		
HDLN NEW	15				AOLTW
CNBC	16	18	18		NBC
VH-1	17	20	20		CBS/VIACOM
QVC	18	16	13		COMCAST
AMC	19	19	19		CABLEVISION
BET	20	14		19	CBS/VIACOM
WGN				9	LOCAL BCAST
CARTOON		5		6	AOLTW
SCI-FI	5	5		15	LIBERTY
TLC			16	12	LIBERTY
HISTORY				11	ABC/DISNEY
ESPN2			17		FOX
DISNEY				3	ABC/DISNEY
FOX NEWS				9	FOX

Source: Federal Communications Commission, *Video Competition*, First and Tenth Annual Reports.

new networks created in the decade after the 1992 Act, only 6 do not involve ownership by a cable operator or a national TV broadcaster. Eighteen of these cable networks have ownership by the top four cable MSOs. TV broadcasters are involved in 15. These numbers contradict the claim that there has been a dramatic change in the programming environment. The number of independent networks as a percentage of the total has remained about the same, as has the number of subscribers to independent networks.

Similarly, a recent cable analysis identified eleven networks that have achieved substantial success since the passage of the 1992 Act. Every one of these is affiliated with an entity that has guaranteed carriage. Five of these are also associated with a strategy of

Exhibit IV-2: Lack of Independent Programming Entry

Network	Launch	Owner
Cartoon Network	1992	MSO
Sci-Fi Network	1992	MSO
Turner Classic Movies	1994	MSO
Independent Film Channel	1994	MSO
WAM! Kidz Network	1994	MSO
Much Music USA	1994	MSO
Golf Channe	1995	MSO
Outdoor Life	1995	MSO
Great Amer.	1995	MSO
Animal Planet	1996	MSO
CNNFI	1996	MSO
CNNSI	1996	MSO
BET Jazz	1996	MSO
WE: Women's Entertainment	1997	MSO
Discovery Health Channel	1998	MSO
Tech TV	1998	MSO
Style	1999	MSO
Oxygen	2000	MSO
TV Land	1996	BROADCAST
Soapnet	2000	BROADCAST
Nat. Geog	2001	BROADCAST
ESPN 2	1993	BROADCAST
FX Network	1994	BROADCAST
History Channel	1995	BROADCAST
ESPN Classic	1995	BROADCAST
Fox News Channel	1996	BROADCAST
MSNBC	1996	BROADCAST
Speedvision	1996	BROADCAST
ESPNews	1996	BROADCAST
Fox Sports	1996	BROADCAST
LMN	1998	BROADCAST
Home & Garden	1994	BROADCAST
Food	1993	BROADCAST
Flix	1992	INDEPENDENT
Game Show Network	1994	INDEPENDENT
Bloomberg	1995	INDEPENDENT
Health	1998	INDEPENDENT
Goodlife	1998	INDEPENDENT
Ovation	1998	INDEPENDENT

Source: Sources: Joskow Paul, and Linda McLaughlin, "An Economic Analysis of Subscriber Limits," attached to Comments of AOL Time Warner In *The Matter of Implementation of Section 11 of the Cable Television Consumer Protection and Competition Act of 1992 Implementation of Cable Act Reform Provisions of the Telecommunications Act of 1996 The Commission's Cable Horizontal and Vertical Ownership Limits and Attribution Rules Review of the Commission's Regulations Governing Attribution Of Broadcast and Cable/MDS Interests Review of the Commission's Regulations and Policies Affecting Investment In the Broadcast Industry Reexamination of the Commission's Cross-Interest Policy*, CS Docket No. 98-82, CS Docket No. 96-85, MM Docket No. 92-264, MM Docket No. 94-150, MM Docket No. 92-51, MM Docket No. 87-154. January 3, 2002, Table 2, Writers Guild of America. "Comments of the Writers Guild of America Regarding Harmful Vertical and Horizontal Integration in the Television Industry." Testimony before the Federal Communications Commission, *In the Matter of Implementation of Section 11 of the Cable Television Consumer Protection and Competition Act of 1992 Implementation of Cable Act Reform Provisions of the Telecommunications Act of 1996 The Commission's Cable Horizontal and Vertical Ownership Limits and Attribution Rules Review of the Commission's Regulations Governing Attribution Of Broadcast and Cable/MDS Interests Review of the Commission's Regulations and Policies Affecting Investment In the Broadcast Industry Reexamination of the Commission's Cross-Interest Policy*, CS Docket No. 98-82, CS Docket No. 96-85, MM Docket No. 92-264, MM Docket No. 94-150, MM Docket No. 92-51, MM Docket No. 87-154., 2002; Federal Communications Commission, *Tenth Annual Report on Video Competition, 2004* Tables D-1, D-2, D-3.

launching with scraps from the cutting room floor/or as a spin off of a sister channel. In the case of the spin offs, they use the name of the successful show and focus on a subcategory of issues or ideas originally covered by the hit show (CNN begets CNN Headline News and CNNFI). In the case of cutting room floor shows (particularly news), they use content created but not used by the hit show, in addition to simply reusing content that was already used.

Viewers receive a ten-second sound byte on the broadcast news and a three-minute interview on the cable news. There are three networks on this list with fewer than twenty million subscribers, two associated with broadcasters and one with an MSO. Three have disappeared, having been acquired by dominant programmers in the same category.[163]

Moreover, each of the dominant programmers has guaranteed access to carriage on cable systems – either by ownership of the wires (cable operators) or by carriage rights conferred by Congress (broadcasters) (see Exhibit IV-3). When we examine the ownership of all the networks, we discover that almost three-quarters of them are owned by six corporate entities.[164] The four major TV networks, NBC, CBS, ABC, Fox, and the two dominant cable programmers AOL Time Warner and Liberty, completely dominate the tuner. These six firms account for three-quarters of the subscribers, writing budgets, programming expenditures and primetime viewing.

Exhibit IV-3: Dominant Video Program Producers/Distributors

	Subscribers		Writing Budget		Programming Expenditures		Production Share of Prime Time Hours in %
	# Million	%	$ Million	%	$ Million	%	
FOX/LIBERTY	1250	21	236	19	3803	9	3
TIME WARNER	925	15	206	17	7627	18	10
CBS/VIACOM	910	15	145	12	9555	22	28
ABC/DISNEY	705	12	132	11	6704	16	21
NBC/Vivendi	720	12	159	13	3879	9	21
Subtotal	4315	75	772	72	31568	74	83
TOTAL	6000	100	1225	100	43212	100	100

SOURCES: Federal Communications Commission, *In the Matter of Annual Assessment of the Status of Competition in Markets for the Delivery of Video Programming*, CC Docket No. 00-132, Seventh Report, Tables D-1, D-2, D-3, D-6, D-7; *Television Market Report*: *2001* (Washington, D.C.: BIA Financial Network, 2001); Comments of the Writers Guild of America Regarding Harmful Vertical and Horizontal Integration in the Television Industry, Appendix A. Federal Communications Commission, *In the Matter of Implementation of Section 11 of the Cable Television Consumer Protection and Competition Act of 1992 Implementation of Cable Act Reform Provisions of the Telecommunications Act of 1996 The Commission's Cable Horizontal and Vertical Ownership Limits and Attribution Rules Review of the Commission's Regulations Governing Attribution Of Broadcast and Cable/MDS Interests Review of the Commission's Regulations and Policies Affecting Investment In the Broadcast Industry Reexamination of the Commission's Cross-Interest Policy*, CS Docket No. 98-82, CS Docket No. 96-85, MM Docket No. 92-264, MM Docket No. 94-150, MM Docket No. 92-51, MM Docket No. 87-154, January 4, 2002; Bruce M. Owen and Michael G. Baumann, "Economic Study E; Concentration Among National Purchasers of Video Entertainment Programming," *Comments of Fox Entertainment Group and Fox Television Stations, Inc., National Broadcasting Company, Inc. and Telemundo Group, Inc., and Viacom*, In the Matter of 2002 Biennial Regulatory Review – Review of the Commission's Broadcast Ownership Rules and Other Rules Adopted Pursuant to Section 202 of the Telecommunications Act of 1996, Cross Ownership of Broadcast Stations and Newspapers, Rules and Policies Concerning Multiple Ownership of Radio Broadcast Stations in Local Markets, Definition of Radio Markets, MB Docket No. 02-277, MM Dockets 02-235, 01=317, 00-244, January 2, 2003; Federal Communications Commission, *Program Diversity and the Program Selection Process on Broadcast Network Television*, Mara Epstein, Media Ownership Working Group Study 5, September 2002, pp. 26.

To underscore the dominance of this tight oligopoly we have analyzed the networks that FCC Chairman Powell claimed in an opinion piece on the FCC's new media ownership rules are the major competitors for broadcast TV.[165] Chairman Powell identified seventeen cable and satellite networks that he believes compete with the broadcast networks. As Exhibit IV-4 shows, thirteen of these are owned by the same corporations that own the networks and two are owned by a firm with a substantial ownership interest in one of the major network owners.

Both the *Sinclair* and *Prometheus* courts have affirmed the long-standing Supreme Court jurisprudence that diversity in the media means diversity of ownership. By that standard, the cable system is an utter failure.

Exhibit IV-4: Powell's Broadcast Competitors Are Owned By Broadcasters

PARENT Corp.	**DISNEY**	**VIACOM**	**GE/ Vivendi**	**NEWSCORP/ Liberty***	**AOL-TIME Warner**
Broadcast Networks	ABC	CBS UPN	NBC Telemundo	Fox	WB
Cable Competitors Identified By Powell	ESPN History**	Showtime Nickelodeon BET	MSNBC USA SciFi History**	Fox Sports Discovery* Hallmark*	HBO CNN Cartoon

* Liberty has a substantial investment; ** Joint Venture

Not shown above, Univision and IFC are independent of the six dominant integrated TV firms.

V. ANTI-CONSUMER BUNDLING

As part of the process of placing blame on programmers for rising prices, several of the industry studies are framed as responses to consumer analyses that have documented the abuse of market power by cable operators. Comcast[166] and the National Cable Telecommunications Association (NCTA)[167] assert that when consumer advocates complain about the total price of cable service, they are failing to take into account that the monthly bill includes more networks and are confusing real prices with nominal prices. NCTA goes so far as to offer a new approach to indexing cable prices as an alternative to the Bureau of Labor Statistics Consumer Price cable index. The FCC's *Tenth Annual Report* cites this analysis as further support for its conclusion that competition in the multichannel video market is robust, and repeats the industry arguments.[168]

This section shows that the most frequent statement of the complaint by consumer advocates – cable "rates have risen and continue to rise almost three times faster than inflation,"[169] – is correct. The consumer advocate comparison states the numerator and the denominator of the real fraction in a fashion that is more meaningful to consumers and policymakers because it gives the reference points. Moreover, a close look at the pattern of bundling imposed on the public shows that, if anything, the BLS cable price index is more likely to be understating price increases than overstating them.

The bottom line is that the market power-based abuse of consumers by cable operators has been growing since the passage of the Telecommunications Act of 1996. After two decades of abusive pricing, cable operators may have begun to encounter some resistance, so increases may slow, but that does not mean the abuse will be reduced or eliminated. Moreover, the cable operators have launched new bundling strategies that shift the focal point of price increases and anticompetitive harm to other areas.

A. Estimation of Quantity Adjusted Price Changes

NCTA seeks to demonstrate that there was a substantial increase in consumer surplus after the Telecommunications Act of 1996 by claiming that the real price of quality-adjusted service has declined. In this section, we demonstrate that this basic claim is incorrect and the whole welfare improvement argument overstated. The cable industry estimates involve a series of analytic errors of commission and omission and the general claims of increases in consumer welfare have several fundamental flaws.

First, there is a misspecification of the units of analysis. The NCTA uses the total number of viewing hours as the measure of consumption. Since the output is the total amount of consumption, the price should be the total amount paid for the products consumed. However, in its welfare calculation, NCTA uses the BLS consumer price index for services. NCTA recognizes, however, **that the BLS index has already been adjusted downward for increases in the quantity of channels available and other factors**. Therefore, the NCTA

double counts quantity changes. In the analysis below, we use the actual price paid for the total bundle of programs.[170]

Second, NCTA chooses to start its analysis eighteen months after the passage of the Telecommunications Act of 1996, conveniently excluding eighteen months of the most rapid rate increases in the history of the industry.

Third, there would also appear to be a mismatch between the estimate of increased viewing and the estimate of declining prices. Since viewing numbers are seasonal and January is roughly the mid-point, we use January prices.[171]

The cable industry estimates that in the 1995/1996 season, the average cable household watched 23.4 hours of advertiser supported cable networks per week (see Exhibit V-1). We estimate that in January 1996, which coincidentally is the month before the 1996 Telecommunications Act was signed, the average monthly bill was $22.60. The average cost per weekly viewing hour to the consumer was $.966. The cable industry estimates that in the 2002/2003 season, the average cable household watched 34.7 hours of advertiser supported

Exhibit V-1: Cost of Viewing, 1996 & 2003

Market Condition	Viewing Hours	Monthly Cost	Cost/ Viewing Hour Nominal	Cost/ Viewing Hour Real
1/1/96 Noncompetitive	23.4	$22.60	$.966	$.966
1/1/03 Noncompetitive switching has full value	34.7	41.60	1.198	1.019
1/1/96 Noncompetitive	23.4	$22.60	$.966	} 58.9
1/1/03 Noncompetitive switching valued 1/3 at the margin	27.1	41.60	1.535	
BLS INCREASE (1/1/96 to 1/1/03)				48.5

Source: For hours of viewing, Cable TV Advertising, Weekly Viewing of Ad-Supported Cable per Cable Household, and Source: NCTA, Steven S., *Assessing Quality Adjusted Changes in the Real Price of Basic Cable Service*, attached to Comments of the National Cable Telecommunications Association, in Federal Communications Commission, *In Re: The Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, MB Docket No. 03-172, September 11, 2003, p. 12. Cable prices for noncompetitive systems from Federal Communications Commission, *Report on Cable Prices*, January 2, 1997, p. 12, May 7, 1999, p. 9; June 15, 2000, p. 9; Feb 14, 2001; 9; April 4, 2002, *p. 8;* July 8, 2003, p. 10; General Price increases from Bureau of Labor Statistics, Consumer Price Index.

cable networks per week. We estimate the average price in January 2003 to be $41.60 per month. The average cost per weekly viewing hour was $1.199. That is a nominal increase of 24 percent. Inflation over the period was 17.7 percent, so the real increase was 5.5 percent. This is a very different picture than the 15 percent decline that NCTA claims by double counting quality improvements.

B. Bundling, the Demand Curve and Consumer Surplus

These simple math problems that afflict the industry analysis are compounded by conceptual issues. Bundling is the central character in the current drama surrounding cable prices and this wreaks havoc with the NCTA estimate of consumer welfare. The failure of cable operators to offer cable channels on an unbundled basis makes it difficult to divine the demand curve for individual channels. NCTA mentions, in passing, that viewing is not evenly distributed, but that does not influence its calculation.

The top 10 cable programs account for 50 percent of all viewing that is significant enough to be registered by Nielsen. The top 20 shows account for 75 percent of all such viewing. The GAO reports that the typical household watches only 17 channels. People are being forced to buy a lot of programs they don't watch to get the ones they want. Although the bottom 30 shows that register on the Nielsen scale pass an average of just under 70 million homes, only about a quarter of a million households watch them during any given day. For every one household watching, approximately 250 who are forced to pay for it in the bundle are not. For the bottom two shows, the ratio is 1 to 800. Over 250 additional cable networks do not capture enough viewers to even register on the Nielsen scale.[172] If advertisers are paying substantial sums for these blank TV screens, as cable companies claim, they are wasting a lot of money.

NCTA assumes (or at least uses in every example and hypothetical case) that demand is linear and that elasticity does not change over time. Both of these assumptions are dubious at best. Cox assumes demand is linear, equal and uncorrelated across individual channels to work its example of consumer benefit from bundling.[173] This, too, is dubious, at best.

Comcast's approach provides a useful starting point. It likens cable bundling to a greengrocer who sells tomatoes for $2 per pound, but who might also sell five pounds for $7.50. The tomatoes are cheaper on a per unit basis in the bundle (a volume discount) although the total bill is greater. The fundamental problem is that greengrocers invariably give the consumer a wide range of choices. The consumer can buy half a pound of tomatoes, or three pounds, or take the five-pound discount, as his or her needs may dictate. Cable operators do not give consumers that much choice.

In fact, cable operators give consumers almost no choice. If I really need two pounds of tomatoes for my spaghetti sauce, I have to take all five pounds and most of the other fruits and vegetables, even though the rest are of little value to me.[174] My next door neighbor, who really needs two pounds of apples for her pie, is forced to buy five pounds of apples and the

tomatoes and all the other fruits and vegetables, too. We both end up paying a higher price and, given the nature of the commodity, we cannot recapture the surplus through trade. It is conceivable that we could split the cost, but then I have to have my neighbors in my house all the time watching their channels. If we buy one subscription and try to run a wire (or a wireless network) between our houses, the cable operators have us arrested for stealing their signal.

This is an illustration of extraction of consumer surplus that can be found in the economic and marketing literatures.[175] The companies never offer channels on an *a la carte* basis to determine if consumer demand exists. Consumers are forced to pay for the added, low value channels because they do not want to give up the whole bundle. Since there is little competition and the competitors offer bundles too, there is no real alternative. Cable industry claims that its prices should be evaluated on a per channel basis must be rejected by policymakers for the simple reason that they do not allow consumers to buy its services that way. Consumers are forced to take or leave the entire bundle, even if they only want a small part of it.

Given the lack of a demand curve for individual channels, NCTA's other assumptions are questionable. NCTA's welfare analysis assumes a full hour of increased welfare when a consumer shifts from watching a broadcast show to watching a cable show. That is, if a consumer watches a rerun of "Law and Order" on USA instead of NBC, NCTA claims the full hour as an increase in the consumer's welfare. In fact, there may be little welfare gain. If the consumer had shifted from watching "West Wing" to watching "Law and Order," one could argue that there is a welfare gain, but it is only the marginal difference between the two, not the total. Because the channels are all forced into the bundle, we cannot tell what consumers would pay for them on a stand-alone basis.

If total hours of viewing had increased as much as cable viewing, the assumption that every hour watched on cable represents a full hour of gained consumer welfare would be more plausible, but that is not the case. The increase in total viewing is considerably less than the increase in cable viewing. In contrast to the 5.7 percent per year increase claimed by cable operators for viewing of advertiser supported cable networks, the FCC cites estimates of less than a 1.5 percent per year increase in viewing over a similar period,[176] while others show less than a one percent per year increase. A well respected industry source that estimates both total TV viewing hours and basic/expanded cable network viewing hours puts the total increase of viewing at under one-quarter of the cable switching increase.[177] Even if we assume that the entirety of increased TV viewing occurred in cable households, we would still conclude that the net increase in viewing was equal to slightly over one-third of the total increase in cable network viewing.

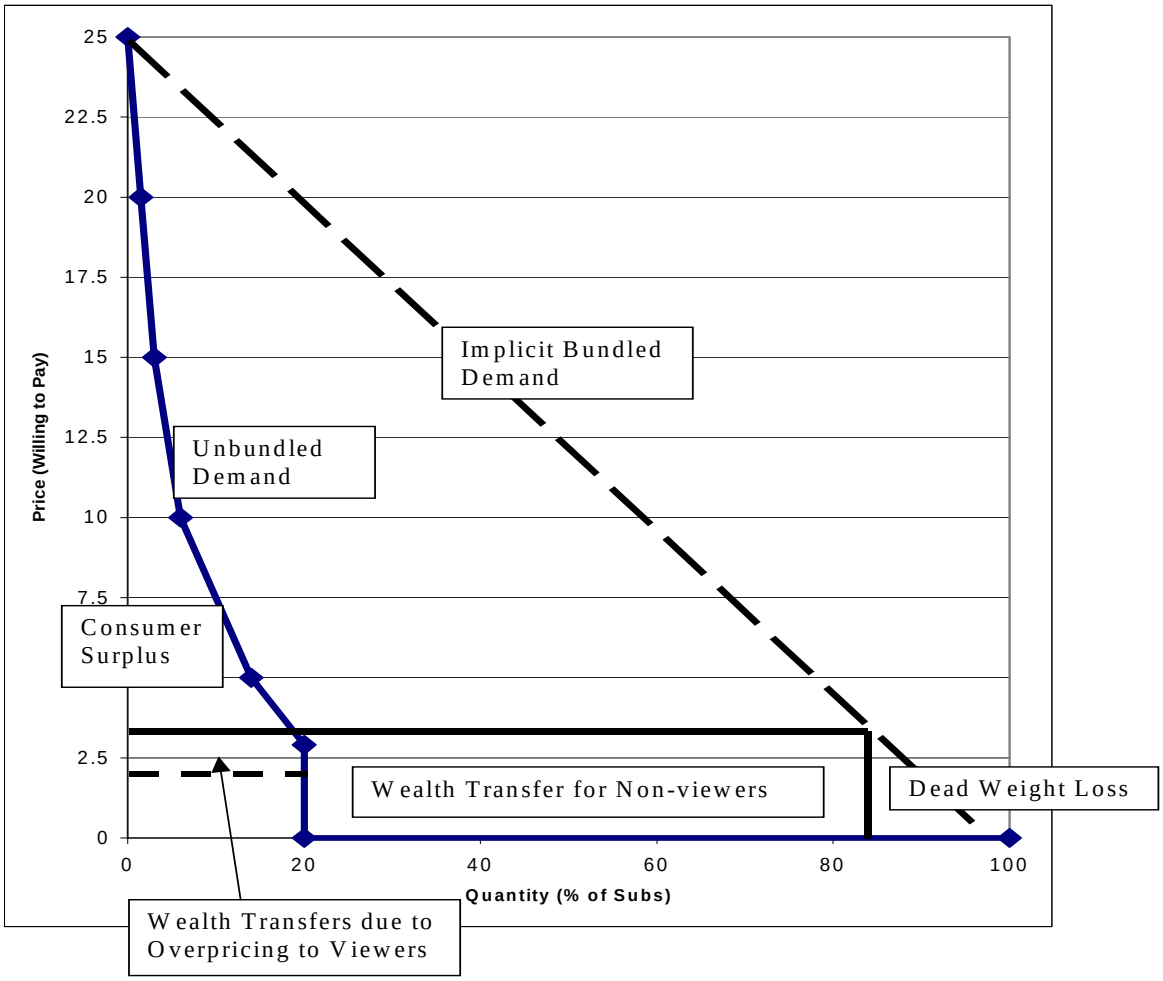
If we assume that the actual increase in consumer welfare is equal to one-third the total increase in cable viewing (leaving some room for a marginal increase due to switching), the quality-adjusted cost would be $1.54 (see Exhibit V-1). The increase in the price over the 1996–2003 period would be almost 60 percent. Interestingly, the quantity and quality adjusted

price as reported by the BLS increased by 49 percent over this period. Thus, the case against the BLS price index is not convincing. In fact, the BLS may be over-adjusting for quantity and quality because many channels are forced into the bundle that few people are watching.

A recent study by Deutsche Bank of the Cox – ESPN controversy reinforces the conclusion that bundling leads NCTA to overestimate the welfare gains (see Exhibit V-2).[178] ESPN is one of the most popular and the most expensive cable networks, yet seventy-eight percent of respondents said that they would not pay $2 per month for it if they were given the choice. Cox confirms this estimate, noting that less than a quarter of its subscribers are "avid sports fans."

There is good reason to believe that the elasticity of demand for ESPN alone is a lot higher than for the bundle and that the bundling of sports programming into the most popular package is harming consumers. The three-quarters of cable viewers who say they would not

Exhibit V-2: Wealth Transfer and Consumer Surplus For ESPN



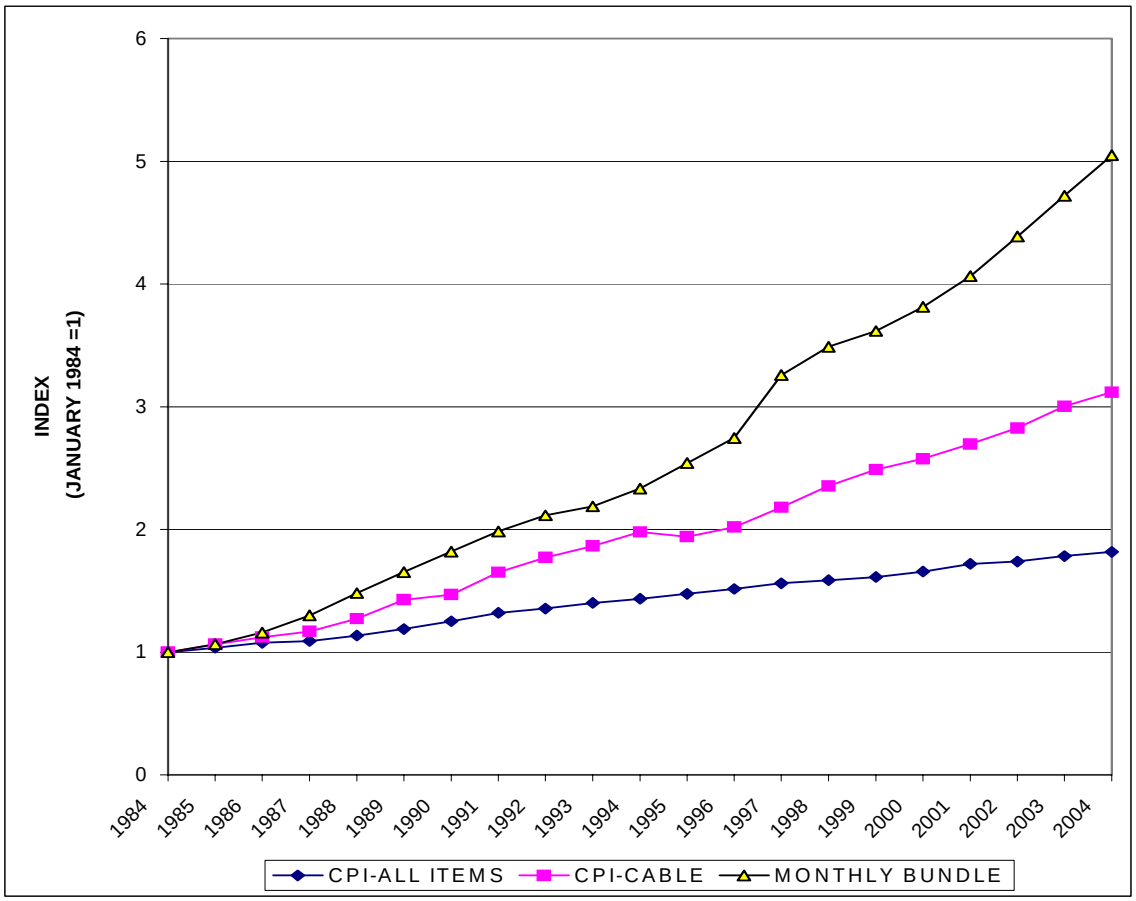
Source: Deutsche Bank, *Walt Disney Company*, October 27, 2003, p. 16.

pay $2 dollars for ESPN, likely the three-quarters who are less than avid sports fans, are paying over $1.5 billion for it in the bundle annually (at Cox's cost).[179] Exhibit V-2 shows the wealth transfers and efficiency losses associated with ESPN. For every one dollar of consumer surplus, there is at least one dollar of wealth transfer. This does not include the wealth transfers associated with the overpricing of ESPN to those who would take it, which may equal another quarter of the consumer surplus. The deadweight efficiency losses are an additional cost associated with this anti-consumer bundling.

C. The Long-Term Problem of Cable Bundling

The cause of the twenty year long struggle over deregulated cable prices, and the intense scrutiny that is now being applied to bundling, can be readily appreciated by examining the long-term trend of cable prices (see Exhibit V-3). The sharp difference between

Exhibit V-3: Cable TV Prices



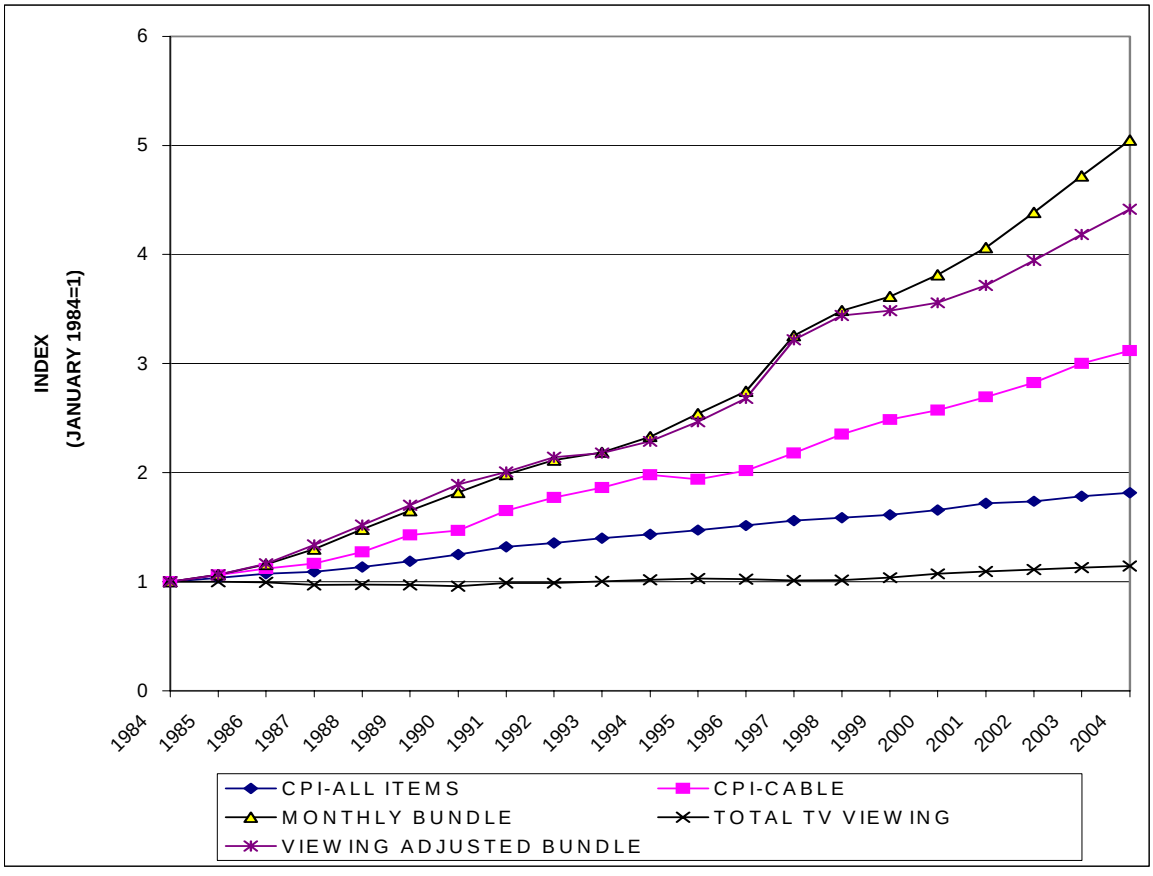
Sources: Bureau of Labor Statistics, Data base, Kagan Associates, *History of Cable TV Subscribers and Revenues;* Federal Communications Commission, *Report on Cable Prices*, various issues.

the BLS-quantity adjusted price and the total bundle price underscores the problem consumers confront as a result of bundling. The price of the bundle has increased more than 60 percent faster than the BLS cable index. Over a twenty year period, when the CPI for all items was increasing by a compounded annual rate of 3.1 percent, the BLS cable price index increased by 5.9 percent, and the bundled price increased by 8.4 percent.

If we make a quality adjustment to the bundle price based on total TV viewing, we still find a major problem (see Exhibit V-4). The average annual price increase for the viewing adjusted bundle is 7.7 percent. In other words, it is about 2.5 times the rate of inflation, sustained over twenty years.

The data suggest that cable operators have pushed prices into the range where there is price resistance (i.e., the more elastic portion of the demand curve). That does not mean the

Exhibit V-4: Cable TV Prices and TV Viewing



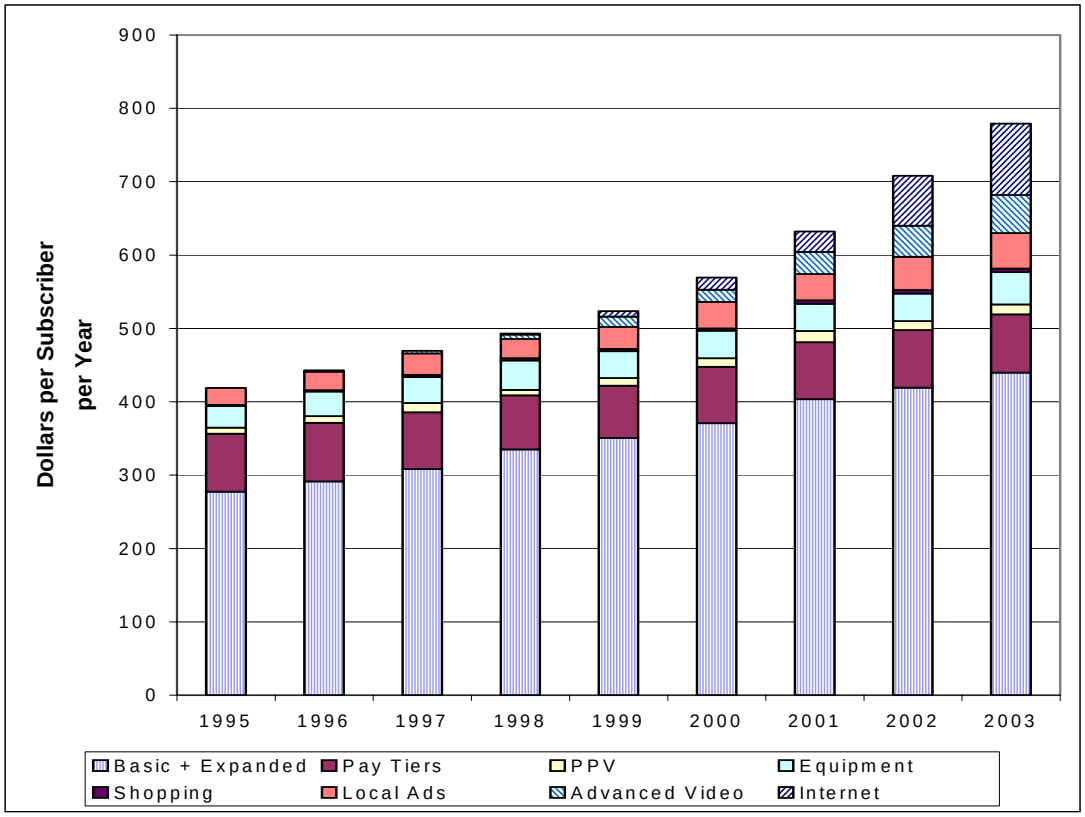
Sources: Bureau of Labor Statistics, Data base, Kagan Associates, *History of Cable TV Subscribers and Revenues;* Federal Communications Commission, *Report on Cable Prices,* various issues; U.S. Census Bureau, *Statistical Abstract of the United States*, "Media Usage and Consumer Spending," various issues; Veronis Suchler Stevenson, *Communications Industry Report*: *Forecast Summary, 2003*.

abuse has stopped, it simply means it may not grow as quickly as in the past, but cable operators are aggressively finding ways to keep their producer surplus growing, like rebundling (retiering) programming to drive penetration of digital tiers.[180]

D. Cash Flow Analysis

Despite a great deal of the talk about changes in technology and more aggressive efforts to stimulate competition in the 1996 Telecommunications Act, rate increases during the period since its passage have been similar to increases in the period after the passage of the 1984 Act, when rates were partially, then fully, deregulated. In fact, rate increases resumed their earlier deregulated pattern of relentlessly rising at two to three times the rate of inflation. As we have seen, the market power of the cable operators is apparent to the consumer in the pattern of pricing and monopoly profits since the passage of the Telecommunications Act of 1996. Advertising and advanced service revenues have been growing even faster, and total revenue is up almost 60 percent (see Exhibit V-5).[181] On a per subscriber basis, monthly

Exhibit V-5:
Increasing Revenues Per Subscriber



Source: Federal Communications Commission, *In the Matter of Annual Assessment of the Status of Competition in Markets for the Delivery of Video Programming*, Fifth Annual Report, December 23, 1998, Table B-7; Ninth Annual Report, December 2002, Table 4; Tenth Annual Report, Table 4.

revenues are up over 50 percent. In the longer term, the ability to raise prices at several times the rate of inflation is evident. With the exception of the short period of regulation in 1992-1996, cable prices have been largely unregulated.

To assess whether the rate increases of recent years have been abusive, we analyze cash flow. We use 1995 as the base year, since the Telecommunications Act of 1996 was signed in early February. For several reasons, it is important to capture this whole period. Industry analyses, as well as the GAO, choose a very short time frame, 1999 – 2002, and miss critical factors.[182]

First, the upgrade of the cable plant began well before 1999, as did the post-1996 Act rate increases. By 1999, the cable industry had already upgraded one-third of its plant. Rates for basic+ expanded service had already increased by 50 percent and net operating income (operating revenue minus operating costs) had increased by over 25 percent. In fact, just one year after the passage of the Telecommunications Act of 1996 the issue of cable rate increases had already arisen. The FCC's cable price report noted that "the Cable CPI increased at a 3.7% compound annual rate from January 1995 to December 1995, and at a 8.5% compound annual rate for the eleven months from January 1996 to November 1996."[183] The song and dance about the causes of the increases had already begun, when the Commission declared:

> we note from anecdotal evidence reported in both the trade press and the general news media that cable operators have attributed the recent increases in cable rates to higher programming costs, system upgrades which provide additional channels, and the pass through of the effects of general inflation on operators' costs.[184]

Second, the GAO report does not examine all of the revenues and costs consistently, since it never factors in advertising revenue. It appears to underestimate an important source of revenue, digital tier revenue, and an important cost stream, non-programming operating expenses. The GAO did not break out the revenues from advanced video services that are also made possible by the upgrade.

Third, the upgrade of the physical plant was largely (80 percent) complete by year-end 2002 and capital outlays dropped off dramatically in 2003.[185] Since penetration of high speed Internet is in its early stages, and advanced video services have not yet fully penetrated, cable operators are set to reap huge profits as advanced digital video and Internet services penetrate the market. In other words, capital costs are set to decline sharply, while revenues from the services that are supported by those capital costs are increasing sharply.

For the eight-year period (1995-2003), there has been a $360 increase in revenues per subscriber per year.[186] Revenues per subscriber per year have almost doubled, while the number of subscribers has increased by 10 percent. Total revenues doubled.[187] The new services (advanced video and Internet and to a much lesser extent cable telephony) have come to play a large role in total revenue, projected to make up about one-fifth of the total in 2003. Operating cash flow per subscriber (operating revenues minus operating costs) increased by

$140 from 1995 to 2003. This is an increase of 77 percent per subscriber and 90 percent in absolute terms. This is cash flow that is available for capital service and excess profits. Revenue increases track bundle prices closely.

2. Cash Flow from Traditional Video Services

The GAO cautions that it is difficult to apportion capital costs between the traditional video business and the new lines of business. The same is true with operating expenses. The expert for Cox, recognizes the problem, but conveniently punts:

> In particular, it seems likely that a relatively large share of increased capital costs and perhaps also operating costs may have been incurred in order to permit firms to offer more advanced products than expanded basic service, such as digital tiers of service (including pay per view and video on demand), broadband Internet connections and telephony.
>
> In my opinion, any attempt to allocate a portion of those cost increases to basic analog service (in order to determine if prices for expanded basic service have risen by more than would have been sufficient to cover all cost increases of expanded basic service) would require a long list of assumptions which would be open to question and controversy.[188]

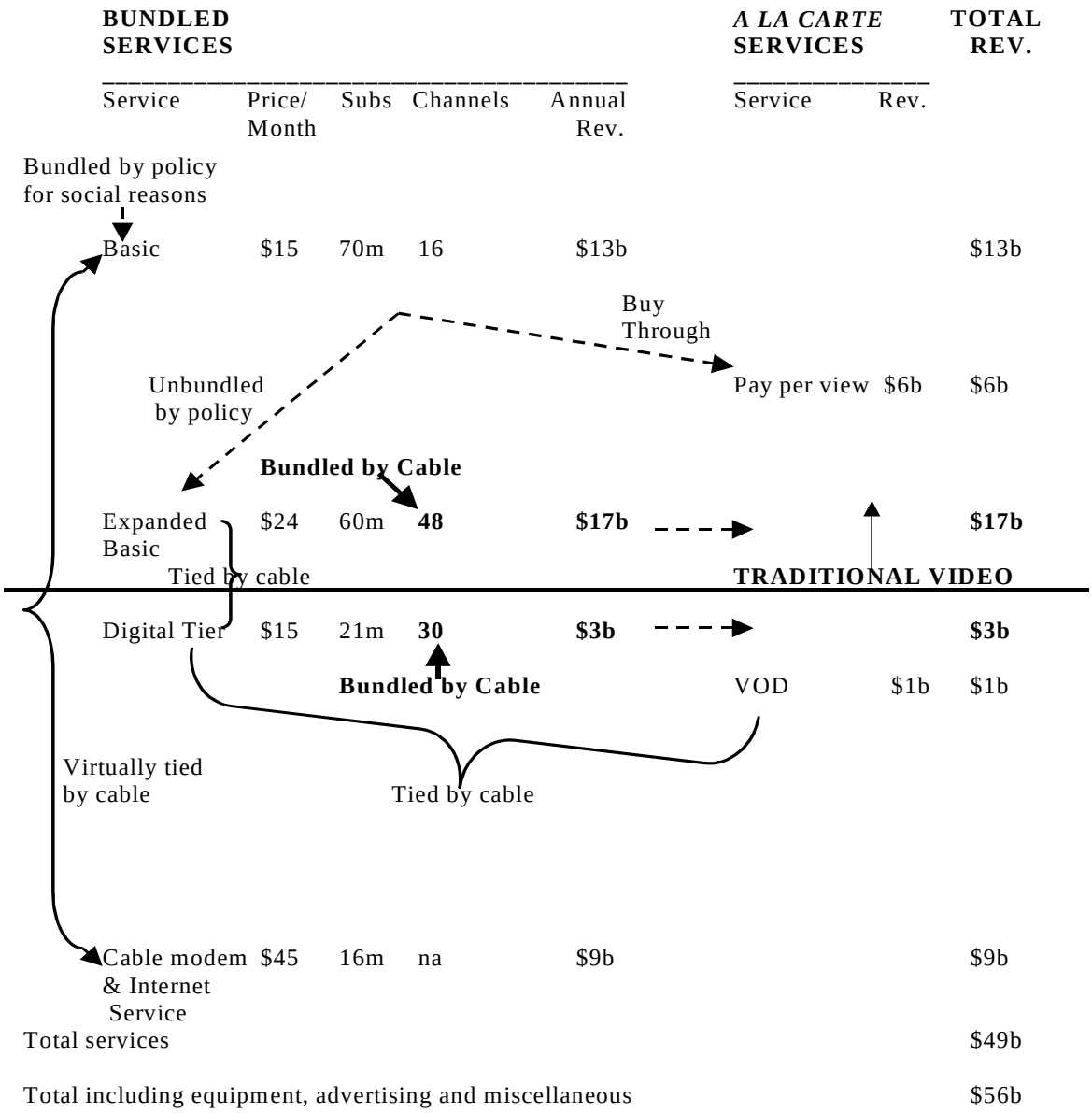
Exhibit V-6 shows the revenue streams that the cable operators have created through bundling and tying. This analysis shows that the top half of the exhibit, the traditional video services, have suffered substantial price increases that go to the bottom line of the cable companies.

Considering a plausible scenario to assess the run-up in cash flow from traditional video businesses shows why the cable industry chooses not to show how much the cost of basic and expanded basic service have increased. Between 1995 and 1998, before advanced video and Internet services were being widely sold to the public, operating expenses increased by about 4.5 percent per year.[189] Between 1998 and 2002, operating costs increased by over 14 percent per year, more than three times the rate prior to the aggressive marketing of advanced and Internet services. There is good reason to believe that the increase in operating expenses was not due to traditional video services.

From 1995 to 1998, cable operators added 3.3 million basic subscribers, just about as many as they added from 1998 to 2002.[190] From 1995 to 1998, cable operators added 117 new advertiser supported cable networks, over 50 percent more such networks than they added from 1998 to 2002.[191] Thus a substantial expansion of subscribers and traditional video services occurred with modest increases in operating costs.

There is no doubt that after 1998, operating cost increases to support advanced video and Internet services increased sharply. One can argue that there was some increase in non-programming operating costs attributable to basic and expanded basic, but little of the capacity

Exhibit V-6: The Cable Industry's Bundling and Tying Strategy and the Stakes in *A La Carte* Programming (Estimated for 2004)



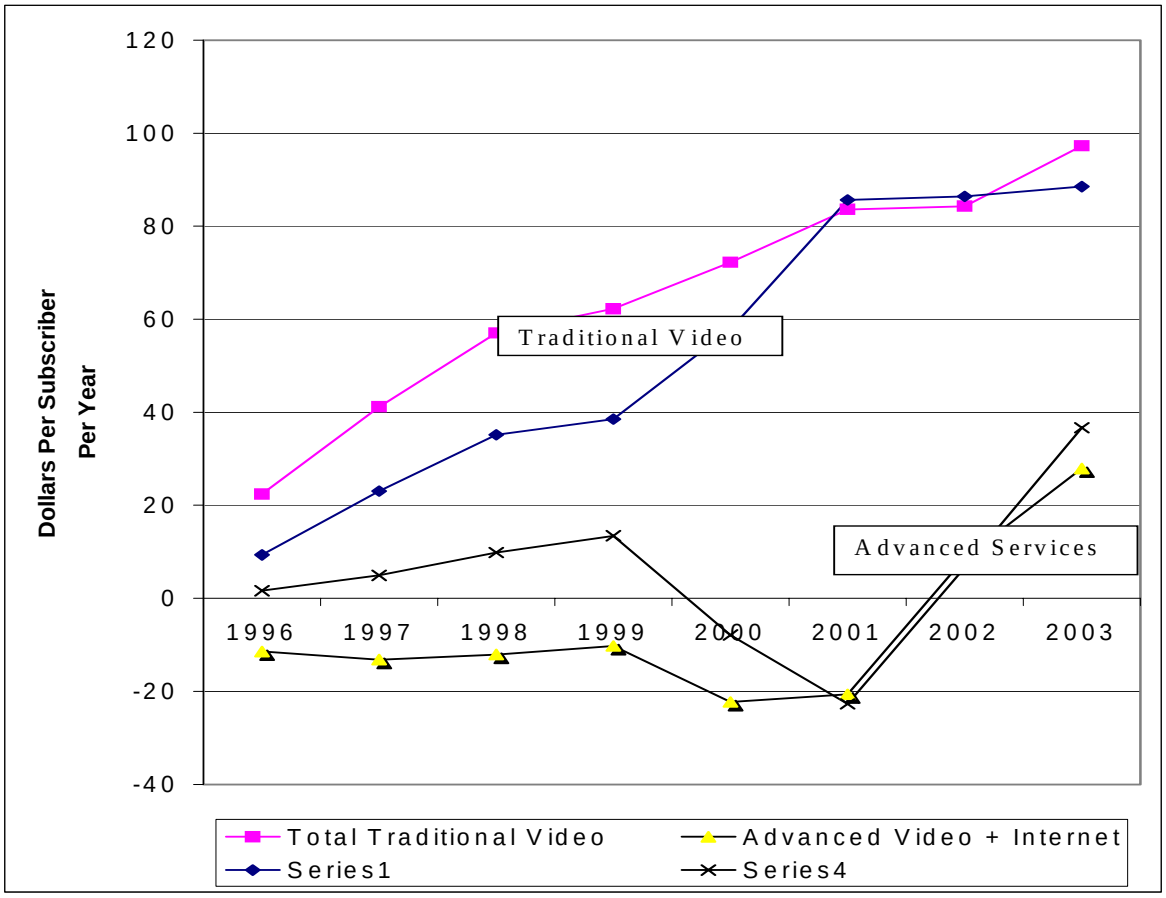
added to cable systems was devoted to that purpose. Full upgrades add the equivalent of 70 or more 6-megahertz channels, only 10 of which have been dedicated to basic and expanded basic. A cautious approach shows the impact.

Exhibit V-7 splits the cash flow into two streams. One stream is made up of traditional video (basic+expanded+pay tiers+pay per view+equipment+shopping+local advertising). The other stream is made up of advanced video and Internet. Operating cost increases have been apportioned under the following two sets of assumptions. All of the pre-1999 operating cost

increases are attributed to traditional video. In one scenario, forty percent of the post-1999 operating cost increases is attributed to traditional video, since the ESPN paper estimates that the increase in programming costs in 1999 to 2002 was equal to 32 percent of the total increase in operating costs.[192] In the second scenario, the post-1999 increase is assumed to be 4.5 percent (the pre-1999 rate) plus $1 additional each year for 2000-2003, which is the average annual increase in programming costs per subscriber in the 1999 to 2002 period. In both cases, the results are similar.

Cash flow grew sharply from traditional video service through 2001 and then leveled out at a very high level. The leveling is due to a combination of increasing programming costs and continually mounting non-programming operating costs attributed to traditional video.

Exhibit V-7: Cumulative Increases in Cash Flow Per Subscriber From Traditional and Advanced Cable Services



Source: Federal Communications Commission, *In the Matter of Annual Assessment of the Status of Competition in Markets for the Delivery of Video Programming*, Fifth Annual Report, December 23, 1998, Table B-7; Ninth Annual Report, December 2002, Table 4; Seventh Annual Report, p. 102. Tenth Annual Report, Table 4. See text for assumptions.

Nonprogramming operating expenses for traditional video are not likely to continue to rise at the assumed rate, certainly not for traditional video services. Therefore, the increase in the cash flow is likely to be permanent. Cash flow from advanced video and Internet services was slightly positive early. It became negative with the major rollout of Internet services, but became sharply positive in 2003.

Consumers of traditional video service have been abused by cable operators and the instrument is bundled pricing.

ENDNOTES

[1] Fabrikant, Geraldine and Bill Carter, "Cable's New Giant Flexes His Muscles," *New York Times*, October 20, 2003; "Testimony of James O. Robbins," *Senate Commerce Committee*, May 6, 2003.

[2] Economists Inc., *Consumer, Operator, and Programmer Benefits from Bundling Cable Networks*, July 2002; Katz, Michael, *An Economic Analysis of the Claims made by Dr. Mark Cooper in "Cable Mergers, Monopoly Power and Price Increases,"* Commissioned by Comcast Corporation, July 28, 2003 (hereafter Comcast); Wildman, Steven S., *Assessing Quality Adjusted Changes in the Real Price of Basic Cable Service,* attached to Comments of the National Cable Telecommunications Association, in Federal Communications Commission, *In Re: The Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, MB Docket No. 03-172, September 11, 2003 (hereafter NCTA); NCTA, *Cable Pricing, Value and Costs*, May 2003.

[3] Eisenach, Jeffrey A. and Douglas A. Truehart, *Rising Cable Rates: Are Programming Costs the Villain?*, supported by ESPN, Inc., October 23, 2003 (hereafter ESPN); Rogerson, William P., *Cable Program Tiering: A Decision Best and Properly Made by Cable System Operators, Not Government Regulators,* November 10, 2003, funded by Cox (hereafter Cox); *Correcting the Errors in the ESPN/CAP Analysis Study on Programming Cost Increases*, November 11, 2003, prepared for Cox Communications (Cox II).

[4] NCTA, *The Pitfalls of A La Carte: Fewer Choices, Less Diversity, Higher Prices*, May 2004.

[5] Consumers Union, *Cable TV Issues Survey*, May 25, 2004; Concerned Women for America, *National Quoram*, April 8, 2004.

[6] NCTA, The Pitfalls.

[7] The only evidence that the industry paper gives on market power is provided by Comcast, which points to one indicator of market power, Tobin's q (the system sales price in comparison to the reproduction cost). Citing numbers from the Federal Communications Commission, *Ninth Annual Report, In the Matter of Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, MB Docket No. 92-145, December 31, 2002, p. 16, Comcast points out that (p. 19): the "National Average Dollar Value Per Subscriber *declined* dramatically, falling from a peak of $5755 in 2000 to $2196 in January through June 2002." This statement fails to take into account the dramatic difference in the nature of the systems being transacted. The average number of subscribers transacted in the peak year Comcast cited was over 250,000 per system in 45 transactions for a total of over $66 billion. The average number of subscribers in the first half of 2002 was only 32,000 in 12 transactions for a total of less than $1 billion. If we compare small systems transacted in 2000 to the small systems transacted in 2002, we get a very different picture; see Federal Communications Commission, *Seventh Annual Report, In the Matter of Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, CS Docket No. 00-132, January 8, 2001, Table C-5. In 2000, there were 39 transactions for systems with fewer than 100,000 subscribers. The average system price was approximately $2,666 per subscriber. Thus, the system price has declined by about 18 percent, which is modest compared to the stock market declines (see Couper, Elise A, John P. Hejkal, and Alexander L. Wolman, "Boom and Bust In Telecommunications," *Economic Quarterly*, Fall 2003). The analysis also does not account for a decline in the reproduction costs, which was also evident.

[8] Scherer, F. M. and David Ross, *Industrial Market Structure and Economic Performance* (Boston: Houghton Mifflin, 1990), pp. 21 – 29. Comcast, pp. 12-13; Cox, Appendix, uses this model as well.

[9] Scherer and Ross, p. 29, offer this observation in the context of identifying social situations and market imperfections that raise questions, other than pure allocative efficiency. These include factors such as society's recognition that there are some members of society "whose preferences cannot be trusted to generate rational choices," that "tastes may (assumed in standard theory of consumer behavior to be stable) have been remolded under a barrage of advertising messages," and that "there are external diseconomies in consumption" that may not be factored into individual choices. "All this warns us that the theory of welfare economics are erected upon sandy foundations. This does not mean that their conclusions are wrong. The demonstration of a competitive system's allocative efficiency makes considerable sense even when complications related to advertising, ignorance, and the like are introduced. But blind faith is also uncalled for."

[10] Early studies include Adams, William James and Janet L. Yellen, "Commodity Bundling and the Burden of Monopoly," *The Quarterly Journal of Economics*, August 1976; Schmalensee, "Gaussian Demand and Commodity Bundling," *The Journal of Business*, January 1984; McAfee, R. Preston, John McMillan and Michael D. Whinston, "Multiproduct Monopoly, Commodity Bundling, and Correlation of Values," *Quarterly Journal of Economics*, May 1989.

[11] Carlton, Dennis W. and Michael Waldman, "The Strategic Use of Tying to Preserve and Create Market Power in Evolving Industry," *Rand Journal of Economics*, Summer, 2002; Rubinfield, Daniel L. and Hal J. Singer, *Open Access to Broadband Networks: A Case Study of the AOL/Time Warner Merger*, 16 Berkeley Tech. L.J. 631, 2001; Ordover, Lansuz A. and Robert D. Willig, "Access and Bundling in High Technology Markets," in Jeffrey A. Eisenach and Thomas M. Lenard (eds.), *Competition, Innovation And The Microsoft Monopoly: Antitrust And The Digital Marketplace* (Washington, D.C.: Progress and Freedom Foundation, 1999); Salop, Steven C., "Using Leverage to Preserve Monopoly," in Jeffrey A. Eisenach and Thomas M. Lenard (eds.), *Competition, Innovation And The Microsoft Monopoly: Antitrust And The Digital Marketplace* (Washington, D.C.: Progress and Freedom Foundation, 1999). Bundling basic video with Internet access has the effect of undermining competition for video services (by driving basic into households and reducing the value of satellite). Bundling video content with Internet access reduces competition for video services, (See, e.g., Comments of the Competitive Broadband Coalition, *Implementation of the Cable Television Consumer Protection and Competition Act of 1992*, Cable Services Bureau Dkt. No. 01-290, at 10-11 [Dec. 3, 2001]). Bundling also raises barriers to entry by forcing competitors to build larger packages to compete: "AT&T is refusing to sell HITS to any company using DSL technology to deliver video services over existing phone lines because such companies would directly compete with AT&T's entry into the local telephone market using both its own cable systems and the cable plant of unaffiliated cable operators. AT&T simply does not want any terrestrial based competition by other broadband networks capable of providing bundled video, voice and data services." (Comments of the American Cable Association In the Matter of: Implementation of the Cable Television Consumer Protection and Competition Act of 1992, Development of Competition in Video Programming Distribution: Section 628(c)(5) of the Communications Act: Sunset of Exclusive Contract Prohibition, CS Docket No. 01-290 [filed Dec. 3, 2001]).

[12] Cox, p. 13.

[13] Cox, p. 13.

[14] Scherer and Ross, 1990, p. 4. Shepherd, William, G., *The Economics of Industrial Organization* Englewood Cliffs, N.J.: Prentice Hall. 1985), p. 5, presents a similar view as do Viscusi, W. Kip, John M. Vernon, and Joseph E. Harrington, Jr., *Economics of Regulation and Antitrust.* (Cambridge: MIT Press: 2000), p. 62.

[15] Scherer and Ross, 1990, p. 4.

[16] The DOJ Guidelines are oriented toward conditions under which a broad range of types of anticompetitive behaviors are sufficiently likely to occur as to require regulatory action. The *Merger Guidelines* recognize that market power can be exercised with coordinated, or parallel, activities and even unilateral actions in situations where there are small numbers of market players. (*Merger Guidelines*, at section 0.1). The area of noncollusive, oligopoly behavior has received a great deal of attention. A variety of models have been developed in which it is demonstrated that small numbers of market participants interacting in the market, especially on a repeated basis, can learn to signal, anticipate, and parallel one another to achieve outcomes that capture a substantial share of the potential monopoly profits. (Taylor, John, B, *Economics* (Boston: Houghton Mifflin, 19989); Viscusi, W. Kip, John M. Vernon, and Joseph E. Harrington, Jr., *Economics of Regulation and Antitrust* (Cambridge: MIT Press, 2000), Chapter 5; Fudenberg, Jean and Jean Tirole, "Noncooperative Game Theory for Industrial Organization: An Introduction and Overview," in Richard Schmalensee and Robert D. Willig, eds. *Handbook of Industrial Organization*. (New York: North-Holland, 1989).

[17]U.S. Department of Justice, 1997.

[18] Shepherd, 1985, p. 389, gives the following formulas for the Herfindahl-Hirschman Index (HHI) and the Concentration Ratio (CR):

$$\sum_{i=1}^{n} 2$$

$$H = \sum_{i=1}^{n} S_i$$

$$CR = \sum_{i=1}^{m} S_i$$

$m \quad i = 1$

where

n = the number of firms

m= the market share of the largest firms (4 for the 4 firm concentration ratio)

S_i = the share of the ith firm.

[19] Viscusi, Vernon and Harrington, 2000, p. 212.

[20] Shepherd, 1985, p. 4, "Tight Oligopoly: The leading four firms combined have 60-100 percent of the market; collusion among them is relatively easy. Loose Oligopoly: The leading four firms combined have 40 percent or less of the market; collusion among them to fix prices is virtually impossible."

[21]Friedman, J.W., *Oligopoly Theory.* (Cambridge: Cambridge University Press.: 1983), pp. 8-9,W"here is the line to be drawn between oligopoly and competition? At what number do we draw the line between few and many? In principle, competition applies when the number of competing firms is infinite; at the same time, the textbooks usually say that a market is competitive if the cross effects between firms are negligible. Up to six firms one has oligopoly, and with fifty firms or more of roughly equal size one has competition; however, for sizes in between it may be difficult to say. The answer is not a matter of principle but rather an empirical matter."

[22] U.S.C. 47, 601.

[23] *Associated Press v. United States*, 326 U.S. 1. 20 (1945).

[24] *FCC v. National Citizens Committee for Broadcasting*, 436 U.S. 775 (1978).

[25] *Red Lion Broadcasting v. FCC*, 395 US 367 (1969).

[26] *Turner Broadcasting System, Inc. v. FCC*, 512 U.S. 622, 638-39 (1994); *Time Warner Entertainment Co., L.P. v. FCC*, 240 F.3d 1126 (D.C. Cir. 2001).

[27] Comcast, p. 14, states the proposition as follows: "As long as the increase in the monthly fee is less than the amount by which consumers value the new programming, they will be better off at the new 'higher' price coupled with the additional programs."

[28] Scherer and Ross, pp. 21 – 29.

[29] Comcast, pp. 12-13; Cox, Appendix, uses this model as well.

[30] Industry defenders frequently claim that rising prices cannot be caused by market power, since in frictionless theory the monopolist would immediately ascertain his profit-maximizing price and charge it (Comcast p. 14, Hazlett, Thomas, *Cable TV: Has Deregulation Failed?*, Manhattan Institute for Policy Research, November 21, 2003). Reality, of course is more complicated. Monopolists price politically, searching for what they can get away with before they evoke a reaction, especially in an industry whose rapacious behavior caused it to be reregulated once.

[31] Cox, Appendix, argues that allowing the monopolist to reallocate rents from programmers will increase its rate of profit as well as consumer welfare under some circumstances.

[32] Sullivan, Lawrence, and Warren S. Grimes, *The Law of Antitrust: An Integrated Handbook, Hornbook Series* (St. Paul: West Group, 2000), pp. 138-139.

[33] Sullivan and Grimes, pp. 138-139.

[34] Sullivan and Grimes, p. 138.

[35] Rubinfeld and Singer, p. 632.

[36]Perry, Martin, K., "Vertical Integration: Determinants and Effects." In Richard Schmalensee and Robert D. Willig, eds., *Handbook of Industrial Organization* (New York: North-Holland., 1989), p. 247.

> [V]ertical mergers may enhance barriers to entry into the primary industry if entrants must operate at both stages in order to be competitive with existing firms and if entry at both stages is substantially more difficult than entry at one stage.

Scherer and Ross, 1990, p. 526.

> To avoid these hazards, firms entering either of the markets in question might feel compelled to enter both, increasing the amount of capital investment required for entry.

[37] Shepherd, 1985, pp. 289-290.

[38] Perry, 1989, p. 247; Shepherd, 1985, p. 294.

[39] Asch, Peter, and Rosalind Senaca, *Government and the Marketplace* (Chicago: Dryden Press. 1895), p. 248.

> Subsidization: The conglomerate firm can choose to behave in a predatory fashion in one market, subsidizing its predation from profits earned elsewhere.
>
> The simple concept involved in cross subsidizing is that conglomerates can use profits from branch A to support deep, "unfair" price cuts by branch B …

Shepherd, 1985, p. 302.

> If all branches of a diversified firm are dominant in their markets, their pooled resources are likely to increase their dominance through greater price discrimination, threats of punitive actions, and so forth.

[40] Scherer and Ross, 1990, p. 524.

> Substitution elasticities of unity and less normally imply that inputs are indispensable, that is, that no output can be produced until at least some use is made of each relevant input. When the monopolist of an input indispensable in this sense integrates downstream, it can make life difficult for remaining downstream competitors. It can refuse to sell the input to them, driving them out of business. Or it can sell it to them at a monopoly price, meanwhile transferring input at marginal cost to its affiliated downstream units, which, with their lower costs, can set product prices at levels sufficiently low to squeeze the rivals out of the market.

[41] There is a growing body of theoretical and empirical analysis that has reinvigorated concerns about the anti-competitive impacts of vertical integration, particularly in the cable industry, see Krattenmaker, T.G., and S. C. Salop, 1986 "Anti-competitive Exclusion: Raising Rivals' Costs to Achieve Power Over Prices," *The Yale Law Journal*, Vol. 92; Ordover, Janusz, A. Oliver Sykes, and Robert D. Willig, "Non-price Anti-Competitive Behavior by Dominant Firms Toward the Producers of Complementary Products," In F. M. Fisher, ed, *Antitrust and Regulation* (Cambridge: MIT Press: 1985).

[42] Perry, 1989, p. 247.

> The *Guidelines* do recognize three major competitive problems of vertical mergers in concentrated industries. First, forward mergers into retailing may facilitate collusion at the manufacturing stage by making it easier to monitor prices or by eliminating a "disruptive buyer."

[43] Asch and Senaca, 1985, p. 248.

[44] Scherer and Ross, 1990, pp. 526-527; Shepherd, 1985, p. 290.

[45] Subcommittee on Communications, Committee on Commerce, Science and Transportation, Subcommittee, United States Senate. Febraury 16-17, 1983.

[46] Subcommittee on Antitrust, Monopolies and Business Rights, Committee on the Judiciary, United States Congress. *Competitive Issues in the Cable Television Industry.* March 17, 1988; Committee on Energy and Commerce, *Report on H.R. 4850,* Senate Committee on Commerce and Science, *Report on S12.*

[47] Federal Communications Commission, *In the Matter of Annual Assessment of the Status of Competition in Markets for the Delivery of Video Programming: Tenth Annual Report*, January 28, 2004 (hereafter, Tenth Annual Report).

[48] Cooper, Mark and Gene Kimmelman, *The Digital Divide Confronts the Telecommunications Act of 1996* (Washington, D.C.: Consumer Federation of America, 1999).

[49] U.S. C. 47,Title II, part 5.

[50] Federal Communications Commission, 1998, Appendix C.

[51]U.S. Department of Justice, 1998. The Department of Justice press release refers to the "cable monopoly." In remarks made at the press conference, Assistant Attorney General Joel Klein added the adjective persistent.

[52] Federal Communications Commission, *High-Speed Services for Internet Access: Status as of December 31, 2003*, June 2004, Table 4.

[53] Cooper, Mark, "Open Access to the Broadband Internet: Technical and Economic Discrimination in Closed Proprietary Networks." *University of Colorado Law Review* Vol. 71, 2000.

[54] Federal Communications Commission. 2002b. "Report on Cable Industry Prices." In The Matter of Implementation of Section 3 of the Cable Television Consumer Protection and Competition Act of 1992, Statistical Report on Average Rates for Basic Service, Cable Programming Service, and Equipment, 2002, p. 20 (FCC 2002b).

[55] Federal Communications Commission. In The Matter of Implementation of Section 3 of the Cable Television Consumer Protection and Competition Act of 1992, Statistical Report on Average Rates for Basic Service, Cable Programming Service, and Equipment. Seventh Annual Report, CS Docket No. 00-132, January 2, 2001b, p. 20, notes that cable operators in only 330 communities have been granted status as effectively competitive on the basis of overbuilding.

[56] Federal Communications Commission, 2002b, Table C-1.

[57] Kagan, Paul Associates. *Major Cable TV System Clusters.* Carmel, California: Paul Kagan Associates 1998; Federal Communications Commission, Tenth *Annual Report.*

[58] Federal Communications Commission, 2001b, p. 34, notes increasing urban subscribers, but figures show that satellite is still disproportionately rural.

[59] Rosston, Gregory, and Howard Shelanski, "Declaration on Behalf of National Cable and Telecommunications Association." In The *Matter of Implementation of Section 11 of the Cable Television Consumer Protection and Competition Act of 1992 Implementation of Cable Act Reform Provisions of the Telecommunications Act of 1996 The Commission's Cable Horizontal and Vertical Ownership Limits and Attribution Rules Review of the Commission's Regulations Governing Attribution Of Broadcast and Cable/ MDS Interests Review of the Commission's Regulations and Policies Affecting Investment In the Broadcast Industry Reexamination of the Commission's Cross-Interest Policy,* CS Docket No. 98-82, CS Docket No. 96-85, MM Docket No. 92-264, MM Docket No. 94-150, MM Docket No. 9251, MM Docket No. 87-154. January 3. 2002, p. 23, give a hypothetical local market with a cable firm having an 80 percent market share and satellite having 20 percent in making a point about the impact of concentration in national markets. They never discuss the local HHI, which would be 6800. This meets the antitrust definition of a monopoly.

[60] U.S. General Accounting Office (U.S. GAO), I*ssues Related to Competition and Subscriber Rates in the Cable Television Industry*, October 2003; Telecommunications: Issues in Providing Cable and Satellite Television Service, October 15, 2003,Appendix IV.

[61] General Accounting Office, *Telecommunications: Issues in Providing Cable and Satellite Television Service*, Washington, D.C., October 15, 2002.

[62] Federal Communications Commission, In Re: The Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming, MB Docket No. 03-172, January 28, 2004, para. 83, citing Federal Communications Commission, First Report In the Matter of Implementation of Section 19 of the Cable Television Consumer Protection Act of 1992, September 28, 1994, para. 57.

[63] Federal Communications Commission, *Report on Cable Prices*, April 4, 2002, Attachment D-1; February 14, 2001, Attachment D-1; June 2000, Attachment D-1; May 7, 1999, C-1.

[64] *Tenth Annual Report*, para. 16.

[65] We assume that 98 percent of cable subscribers lack head-to-head competition (Federal Communications Commission, *In the Matter of the Annual Assessment of the Status of Competition in the Market for Delivery of Video Programming: Ninth Annual Report*, MB Docket No. 02-145, December 31, 2002, para. 115) and 90 percent of those take expanded basic service (ESPN, p. 2). Therefore, 62 million cable households are the victims of abuse of market power. Their bills could be reduced by $8 per month as a result of genuine head-to-head competition and deconcentration of the industry.

[66] U.S. GAO, 2003, Appendix IV.

[67] FCC, *Report on Cable Prices*, April 4, 2002, Attachment D-1; February 14, 2001, Attachment D-1; June 2000, Attachment D-1; May 7, 1999, C-1.

[68] FCC, *Report on Cable Prices*, February 14, 2001, Attachment D-1; June 2000a, Attachment D-1.

[69] The cluster variable was included in the Federal Communications Commission 2000a and 2001b price reports. Its behavior contradicted the FCC theory. It has been dropped from the 2002 report. The MSO size was included in the 2002 report. System size has been included in all three reports.

[70] FCC, *First Annual Report*, Appendix H.

[71] Federal Communications Commission, "Further Notice of Proposed Rulemaking." In *the Matter of Implementation of Section 11 of the Cable Television Consumer Protection and Competition Act of 1992 Implementation of Cable Act Reform Provisions of the Telecommunications Act of 1996 The Commission's Cable Horizontal and Vertical Ownership Limits and Attribution Rules Review of the Commission's Regulations Governing Attribution Of Broadcast and Cable/ MDS Interests Review of the Commission's Regulations and Policies Affecting Investment In the Broadcast Industry Reexamination of the Commission's Cross-Interest Policy,* CS Docket No. 98-82, CS Docket No. 96-85, MM Docket No. 92264, MM Docket No. 94-150, MM Docket No. 92-51, MM Docket No. 87-154. September 13, 2001 (FCC, 2001a), p. 36.

[72] GAO, 2003, Appendix IV.

[73] Landes, W. M. and R. A. Posner, 1981. "Market Power in Anti-trust Cases." *Harvard Law Review*. Vol. 19, 1981, p. 958, provide an example in which an elasticity of demand of 2.5 is considered high, but even assuming a high elasticity of supply, a market share of 61% conveys the ability to set prices 20% above cost.

[74] *Tenth Annual Report*, para. 132. Comcast once again has failed to notice the consistent empirical evidence that finds size and clustering increase prices, contradicting their claim that (pp. 18-19) "there is no reason to think that consolidation of cable ownership at the national level will affect actual competition among cable system operators. Ironically, cable industry experts find that mergers of some monopolists matter (John B. Hayes, Jith Jayaratne, and Michael L. Katz, *An Empirical Analysis of the Footprint Effects of Mergers Between Large ILECS,* April 1, 1999, p. 1; citing "Declaration of Michael L. Katz and Steven C. Salop," submitted as an attachment to *Petition to Deny of Sprint Communications Company L.P,* in *Ameritech Corp. and SBC Communications, Inc., for Consent to Transfer of Control*, CC Dkt. No. 98-141 (filed Oct. 15, 1998) and *Petition to Deny of Spring Communications Company L.P,* in *GTE Corporation and Bell Atlantic Corporation for Consent to Transfer of Control*, CC Docket. No. 98-184 (filed Nov. 23, 1998)) and that size and alternative distribution opportunities affect bargaining (see Rogerson, William P., "A Further Economic Analysis of the News Corp. Takeover of DirecTV," *In the Matter of General Motors Corporation, Hughes Electronics Corporation, and the News Corporation Limited Application to Transfer Control of FCC Authorizations and Licenses Held by Hughes Electronics Corporation to the News Corporation Limited,* MB Docket NO. 03-124, August 4, 2003).

[75] Cooper, Mark, *Cable Mergers and Monopolies* (Economic Policy Institute, Washington, D.C.: 2002), Chapter 7.

[76] U.S. GAO, 2003, Appendix IV.

[77] FCC, *Report on Cable Prices*, April 4, 2002, Attachment D-1.

[78] Cooper, 2002, pp. 21-32.

[79] Comcast Corporation. 2002. "Application and Public Interest Statement." In *the Matter of Applications for Consent to the Transfer of Control of Licenses Comcast Corporation and AT&T Corp., Transferors, To AT&T Comcast Corporation, Transferee*, February 28. p. 66.

[80] Federal Communications Commission, 2001a, p. 36.

[81] Pearce, George, *The Dictionary of Modern Economics* (Cambridge: MIT Press, Cambridge, 1984), p. 94.

> Cross Elasticity of Demand. The responsiveness of quantity demanded of one good to a change in the price of another good.
>
> Where goods i and j are substitutes the cross elasticity will be positive-i.e. a fall in the price of good j will result in a fall in the demand for good i as j is substituted for i. If the goods are complements the cross elasticity will be negative. Where i and j are not related, the cross elasticity will be zero.

Taylor, p. 59.

> A sharp decrease in the price of motor scooters or roller blades will decrease the demand for bicycles. Why? Because buying these related goods becomes relatively more attractive than buying bicycles. Motor scooters or roller blades are examples of substitutes for bicycles. A substitute is a good that provides some of the same uses or enjoyment as another good. Butter and margarine are substitutes. In general, the demand for a good will increase if the price of a substitute for the good rises, and the demand for a good will decrease if the price of a substitute falls.

Bannock, Graham, R.E. Banock, and Evan Davis, *Dictionary of Economics* (London: Penguin., 1987), pp. 390-391.

> Substitutes. Products that at least partly satisfy the same needs of consumers. Products are defined as substitutes in terms of cross-price effects between them. If, when the price of records goes up, sales of compact discs rise, compact discs are said to be a substitute for records, because consumers can to some extent satisfy the need served by records with compact discs. This account is complicated by the fact that, when the price of an item changes, it affects both the REAL INCOME of consumers and the relative prices of different commodities. Strictly, one product is a substitute for another if it enjoys increased demand when the other's prices rises and the consumer's income is raised just enough to compensate for the drop in living standards caused.
>
> Cross-price elasticity of demand. The proportionate change in the quantity demanded of one good divided by the proportionate change in the price of another good. If the two goods are SUBSTITUTES (e.g. butter and margarine), this ELASTICITY is positive. For instance, if the price of margarine increases, the demand for butter will increase (p. 99).

[82] Federal Communications Commission, 2002b, p. 11.

[83] Federal Communications Commission, 2002b.

[84] Federal Communications Commission, 2001b, describes the DBS variable as the level of subscription. Federal Communications Commission, 2002b, uses the DBS dummy variable.

[85]Ordover, Janusz A., "Declaration on Behalf of AT&T." In *The Matter of Implementation of Section 11 of the Cable Television Consumer Protection and Competition Act of 1992 Implementation of Cable Act Reform Provisions of the Telecommunications Act of 1996 The Commission's Cable Horizontal and Vertical Ownership Limits and Attribution Rules Review of the Commission's Regulations Governing Attribution Of Broadcast and Cable/MDS Interests Review of the Commission's Regulations and Policies Affecting Investment In the Broadcast Industry Reexamination of the Commission's Cross-Interest Policy,* CS Docket No. 98-82, CS Docket No. 96-85, MM Docket No. 92-264, MM Docket No. 94-150, MM Docket No. 92-51, MM Docket No. 87-154. January 3. 2002, p. 24, states "the non-cable share of the MVPD business continues to experience an annual growth rate of nearly 20%. Most of this growth has come from luring away existing cable subscribers." Rosston and Shelanski, 2002, p. 8.

[86] Bazinet, Jason B., *The Cable Industry* (J.P. Morgan Securities, Inc. 2001), p. 4.

[87] Boersma, Matthew., "The Battle for Better Bandwidth – Should Cable Networks Be Open?" *ZDNet*, July 11. 1999.

[88] Bazinet, 2001, p. 9.

[89] Centeris, which does weekly surveying of multichannel video households, recently estimated that 40 percent of satellite subscribers live in areas where cable is unavailable. Approximately 41 percent of the respondents to the Consumers Union Survey who have satellite report that they do not have access to cable. In filings at the FCC, DirecTV states that its subscriber base was half urban and half rural. In the recent past, however, it claims that about two-thirds of new subscribers have been from urban areas. Given that over three-quarters of the U.S. population lives in urban areas, satellite subscribers are still disproportionately rural (Federal Communications Commission, 2001b, para 66).

[90] Centeris, 2002, puts this at 2 million. Morgan puts the figure at 2.5 million. In the CU survey, 11 percent of respondents said they subscribe to both, which works out to about 1.8 million households.

[91] The pricing strategy was apparent to some industry observers, as a Cisco publication noted (Abe, George, *Residential Broadband* (*Indianapolis*: Cisco Press, Macmillan Technical Publishing, 1997), p. 217.

> Cable MSO management apparently agrees it is necessary to get more from each subscriber. Since the passage of the Telecom Act of 96, cable operators have taken the opportunity to raise subscription rates more than twice as fast as the consumer price index, clearly not a strategy for getting new households.

[92] Mundy, Alicia, "The Price of Freedom," *MediaWeek*, March 29, 1999, p. 32.

> Congress has been moving at an unusual speed to pass a bill that would give DBS providers the right to beam local network signals to local subscribers …
> "It's not a cure-all," said Hartenstein, who has run DirectTV since its inception in 1990. For one thing, Hartenstein's business plan is not based on beaming local network signals to his customer base, soon expected to top 9 million. Instead, he is suggesting that subscribers buy new antennas to supplement their coverage. DirecTV is working with retailers to have the specialized antennas available at reduced prices. He calls this program "Distant/Terrestrial," meaning he sends you all the cable and movie channels you could dream of (for which he can charge), and you pick up the free network feeds with an extra antenna.
> Furthermore, Hartensteins' game plan does not include fighting for cable customers by undercutting cable prices. Analysts for the DBS and cable industries have figured out which indicate that the average American homeowner will cough up $30 per month for TV. Above that level, both camps believe, many consumers will bolt and run. Hartenstein seems determined to compete on quality and depth of service, not on price.

[93] In trying to explain away the contradictory finding that the cross-price elasticity between cable and satellite had the wrong sign (Federal Communications Commission, 2002b, p. 11), the FCC suggested that the cable operators reporting DBS penetration numbers "is made up almost entirely of small operators, may not be representative of the response to DBS generally." Note that the same representativeness problem that is invoked to discredit the contrary finding of a wrong sign of the price elasticity would also call into question the substitution effect.

[94] Ordover, Janusz, A. 2002b. "Declaration" attached to "Application and Public Interest Statement," In The Matter of Applications for Consent to the Transfer of Control of Licenses Comcast Corporation and AT&T Corp., Transferors, To AT&T Comcast Corporation, Transferee, February 28, 2002 (Ordover 2002b); Ordover, Janusz A., "Declaration on Behalf of AT&T," attached to "Reply to Comments and Petitions to Deny Applications for Consent to Transfer" In The Matter of Application for Consent to the Transfer of Control of Licenses Comcast Corporation and AT&T Corporation, Transferors, to AT&T Comcast Corporation, Transferee, MB Docket NO. 02-70, May 21. Joskow Paul, and Linda McLaughlin, "An Economic Analysis of Subscriber Limits," attached to Comments of AOL Time Warner In The Matter of Implementation of Section 11 of the Cable Television Consumer Protection and Competition Act of 1992 Implementation of Cable Act Reform Provisions of the Telecommunications Act of 1996 The Commission's Cable Horizontal and Vertical Ownership Limits and Attribution Rules Review of the Commission's Regulations Governing Attribution Of Broadcast and Cable/MDS Interests Review of the Commission's Regulations and Policies Affecting Investment In the Broadcast Industry Reexamination of the Commission's Cross-Interest Policy, CS Docket No. 98-82, CS Docket No. 96-85, MM Docket No. 92-264, MM Docket No. 94-150, MM Docket No. 92-51, MM Docket No. 87-154. January 3., 2002c; Rosston and Shelanski, 2002.

[95] Ordover, 2002c, para. 13, 26.

[96] Ordover, 2002a, p. 36; 2002c, para. 15, 35, 36.

[97] Ordover, 2002a, p. 34; 2002c, para 29.

[98] Ordover, 2002a, p. 37.

[99] Joskow and McLaughlin, 2002, p. 9.

[100] Ordover, 2002a, p. 35; Ordover, 2002c, para. 30.

[101] Ordover, 2002c, para. 15; Joskow and McLaughlin, 2002, p. 10.

[102] Ordover, 2002a, pp. 17, p. 36; 2002c, para. 43.

[103] Ordover, 2002c, para. 87.

[104] Ordover, 2002a, pp. 16, 21; 2002c, paras. 11, 74.

[105] Ordover, 2002a, pp. 29-30; 2002c, paras. 74-75.

[106] Ordover, 2002a, p. 40; 2002c, para. 35; Joskow and McLaughlin, 2002, p. 15.

[107] Ahn, Hoekyun, and Barry R. Litman, "Vertical Integration and Consumer Welfare in the Cable Industry." *Journal of Broadcasting and Electronic Media.* Vol. 41. 1997.

[108] See Cooper, 2002, pp. 44-47.

[109] Fabrikant, Geraldine and Bill Carter, "Cable's New Giant Flexes His Muscles," *New York Times,* October 20, 2003; "Testimony of James O. Robbins," *Senate Commerce Committee,* May 6, 2003.

[110] Cox, Appendix A, shows cable profits rising as programming costs fall.

[111] Dimmick, John, and Daniel G. McDonald, "Network Radio Oligopoly, 19261956: Rivalrous Imitation and Program Diversity." *Journal of Media Economics.* . Vol. 14. 2001, p. 201.

> [R]ivalry in the broadcast network television industry have been clearly mapped… patterns of imitation that might be described as rivalrous imitation among the television networks. Program types that were popular, as indexed by ratings, were more likely to be imitated, while less popular program types were not. Imitation takes the form of emulating programs with high ratings and also spin-offs of successful series. As evidenced by other studies, the result of such rivalrous imitation among television networks was a decline in program diversity.

[112] Chipty, Tanseen, "Vertical Integration, Market Foreclosure, and Consumer Welfare in the Cable Television Industry." *American Economic Review.* Vol. 91, 2002 p. 429.

[113] Waterman, David, and Andrew A. Weiss, *Vertical Integration in Cable Television*. Washington, D.C.: AEI Press. 1997, p. 7.

[114] Waterman and Weiss, 1997, p. 66.

[115] Waterman and Weiss, 1997, pp. 93…94.

[116] Chipty, 2000, p. 429.

> [O]perators integrated with basic programming successfully sell more basic cable subscriptions, despite their tendency to exclude certain program services from their distribution networks. These operators stimulate demand by offering somewhat larger basic cable packages with less programming duplication and more premium packages.

[117] Chipty, 2000, p. 429.

> Similarly, operators integrated with premium programming successfully sell more premium subscriptions. While these operators offer fewer premium choices at higher prices, they manage to stimulate demand for premiums services by offering smaller, cheaper basic cable packages.

[118] Chipty, 2000, p. 430.

> Estimates suggest that consumers are better off in integrated markets than in unintegrated markets, although the differences are not statistically significant.

[119] Waterman and Weiss, 1997, p. 109, argue that economic efficiency results in roughly the same menu of programs being offered by integrated and non-integrated programmers, they are just owned by the integrated MSO. Implicit in the process, variety is served at the expense of diversity of ownership and antagonism between owners. They do not show hard evidence of efficiency gains, however.

[120] Chipty, 2000, p. 430.

[121] The efficiency arguments that cause analysts who find discrimination to hesitate in concluding that it is strategically motivated have been criticized by Dertouzos, James N., and Steven S. Wildman, *The Economics f License Fee Discounts.* Submitted on Behalf of Ameritech Corporation. In CS Docket NO. 99-251. August 23. 1999, pp. 14-25, in the context of bilateral bargaining between MSOs and programmers. They argue that the transaction costs that large MSOs point to in order to justify their large discounts on programming are too small to be justified on efficiency grounds. They conclude that it embodies significant strategic discrimination against smaller MSOs. The same logic applies to efficiency gains from vertical integration. If transaction cost savings are small, then the efficiency gains of vertical integration are small as well.

[122] Rosston and Shelanski, paras. 24, 26, 29, 40, 42.

[123] Ordover, 2002c, paras. 35, 45; Shelanksi, 2002, paras. 24, 26, 29, 40, 42.

[124] Viacom International V. Telecommunication Inc., et. al. United States District Court of Southern New York, September 23, 1993.

[125] Yankee Entertainment Sports, *Complaint,* May 5, 2002.

[126] Yankee Entertainment Sports, 2002, para.1, 12.
[127] Yankee Entertainment Sports, 2002, para., 2, 13.
[128] Yankee Entertainment Sports, 2002, para. 16, 29.
[129] Yankee Entertainment Sports, 2002, para. 16, 114.
[130] Yankee Entertainment Sports, 2002, para. 66.
[131] Yankee Entertainment Sports, 2002, para. 70.
[132] Yankee Entertainment Sports, 2002, paras. 53, 67.
[133] Yankee Entertainment Sports, 2002, para. 69.
[134] Yankee Entertainment Sports, 2002, para. 89.
[135] Yankee Entertainment Sports, 2002, para. 107.
[136] Yankee Entertainment Sports, 2002, para. 64.
[137] Yankee Entertainment Sports, 2002, para. 36-40.
[138] Yankee Entertainment Sports, 2002, para. 39.
[139] Yankee Entertainment Sports, 2002, para. 17, 28-29.
[140] Yankee Entertainment Sports, 2002, para. 34-35, 54.
[141] Yankee Entertainment Sports, 2002, para. 30-31.
[142] Yankee Entertainment Sports, 2002, paras. 14, 41.
[143] Yankee Entertainment Sports, 2002, para. 41.
[144] Waterman and Weiss, 1997, p. 56. Keating, Stephen, *Cut Throat: High Stakes and Killer Moves on the Electronic Frontier* (Boulder: Johnson Books, 1999), pp. 17-18, characterizes the incident as described in this paragraph. Recent comments in the program access proceeding summarize these events aptly: "It is also well known that Fox News Channel ("FNC") owes its very existence to Telecommunications, Inc. ("TCI," since acquired by AT&T), whose agreement to carry FNC on systems serving 90% of TCI's subscribers was critical to the successful launch of the network. Not coincidentally, Fox made FNC available to incumbent cable operators on an exclusive basis. Like the saga of News Corp./EchoStar, FNC's launch and subsequent exclusivity to the cable MSOs is a case study of how the largest incumbent cable operators control the destiny of new programming services, and why programmers sell to cable's competitors at their own risk."

Joint Comments, In *The Matter of Implementation of the Cable Television Consumer Protection and Competition Act of 1992, Development of Competition and Diversity in Video Programming Distribution: Section 628 (c)(5) of the Communications Act: Sunset of Exclusive Contract Prohibition*, Federal Communications Commission, CS Dkt. No. 01-290. December 3, 2001, p. 8. "To make room (for Fox News), Malone cleared out existing networks like a bowling ball cracking into the headpin. The arrival of Fox News in Denver pushed Court TV to split the programming day with Spice, a pay-per-view sex network."

According to Grossman, Lawrence, "Bullies on the Block: Cable Television in New York City." *Columbia Journalism Review.* Jan. 11 1997, Fox fought a similar battle with Time Warner. In 1996, Time Warner (who owned a 20% stake in CNN's parent company, Turner Broadcasting) refused to allow any other cable network to compete with CNN on its cable systems. The nation's largest cable operator at the time, TCI, also owned a stake in CNN, and as a result would also not allow any competitive news services on its systems. Consequently, the U.S. public was denied an alternative news service—despite several attempts at entry from major programmers, e.g. NBC, into the 24 hour news channel business—until the consent decree in the merger of Time Warner and Turner forced the cable operators' hands.

Heidi Przybyla, "BBC uses D.C. as Beachhead for American Invasion," *Washington Business Journal*, suggests that even the BBC was stymied by MSOs who had other cable news programming interests. The BBC was prevented by cable MSOs from establishing a cable news channel as far back as 1991. In 1998, the BBC announced it hoped to form agreements with cable operators to carry BBC World, its international news service, within the next two or three years. A CNN spokesman, Steve Haworth, is quoted as saying, "Competition is always good for journalism, but I think that the BBC will find this to be a very tough marketplace for them. Remember, this is a second attempt for them," referring to BBC World's unsuccessful first attempt to gain US cable distribution. BBC World was launched in 1991 but only made its first appearance in the United States in 1997 after it made a deal with 25 public television stations for them to carry daily news bulletins. BBC was only able to secure some digital distribution after it partnered with MSO-linked Discovery Channel, creating the BBC America channel.

[145] Breyer, R. Michelle, "CNN-Style channel planned for Austin," Austin *American Statesman*, August 22, 1998. p. D1; Tyson, Kim, "Belo adds KVUE to Texas TV Holdings," *Austin American-States-man*. February 26. 1999. P. A1. In August of 1998, Time Warner Cable announced that it would launch an all-news, 24-hour TV channel in Austin, Texas to be available to 220,000 area subscribers, with the specific intent of focusing on central-Texas news. The A.H. Belo Corporation, a media company that currently owns 18 broadcast television stations and four daily newspapers nationwide (including 4 stations and the *Dallas Morning News* in Texas), had also planned to start a cable news channel during the following year, "AT&T Pulls Plug on BayTV News Network," Multichannel News, July 9, 2001.

[146] Waterman and Weiss, 1997, p. 73; Davis, 1998, p. 143.

[147] Waterman and Weiss, 1997, p. 65; Davis, 1998, p. 97

[148] "Barry's New Baby," *Cablevision*, June 11, 2001.

[149] "Minority Nets Continue Distribution Push," *Multichannel News*, December 3, 2001, "BET's Lee Searches for Viacom Synergies," *Multichannel News*, December 3, 2001.

[150] Federal Trade Commission, *In The Matter of Time Warner Inc., Turner Broadcasting Systems Inc., Telecommunications Inc. and Liberty Media Corporation, Complaint*, 1997.

[151] Federal Trade Commission, 1997, pp. 8.

[152] Federal Trade Commission, 1997, pp. 8.

[153] *RCN Telecom Service of New York, Inc. v. Cablevision Corp., DIRECTV v. Comcast; EchoStar v. Comcast.* Problems can also occur on an event-by-event basis (see Everest, 2001, p. 4; Gemini Networks, 2001, p. 3.

[154] Joint Comments, p. 14.

[155] American Cable Association, "Comments of the American Cable Association." In *The Matter of Implementation of the Cable Television Consumer Protection and Competition Act of 1992, Development of Competition and Diversity in Video Programming Distribution: Section 628 (c)(5) of the Communications Act: Sunset of Exclusive Contract Prohibition*, Federal Communications Commission, CS Dkt. No. 01-290, December 3, 2001, p. 15.

[156] "Comments of Everest Midwest Licensee LLC dba Everest Connections Corporation." In *the Matter of Implementation of the Cable Television Consumer Protection and Competition Act of 1992, Development of Competition and Diversity in Video Programming Distribution: Section 628 (c)(5) of the Communications Act: Sunset of Exclusive Contract Prohibition*, Federal Communications Commission, CS Dkt. No. 01-290, December 3. 2001, p. 6.; "Comments of Qwest Broadband Services, Inc." In *The Matter of Implementation of the Cable Television Consumer Protection and Competition Act of 1992, Development of Competition and Diversity in Video Programming Distribution: Section 628 (c)(5) of the Communications Act: Sunset of Exclusive Contract Prohibition*, Federal Communications Commission, CS Dkt. No. 01-290, December 3. 2001, p. 4.

[157] Everest, p. 6, American Cable Association, 2001, p. 15.

[158] Comments of the Competitive Broadband Coalition, *Implementation of the Cable Television Consumer Protection and Competition Act of 1992*, Cable Services Bureau Dkt. No. 01-290, at 10-11 [Dec. 3, 2001]), p. 11.

[159] Federal Communications Commission, 2001a, para. 28

[160] Joint Comments, 2001, p. 8.

[161] Qwest, 2001, p. 3; Dertouzos and Wildman, 1999.

[162] Joint Comments, 2001, p. 9.

[163] Moss, Linda, "DCI Buys Some Health." *Multichannel News*, September 3. Multichannel News. 2001. "AT&T, 2001.

[164] One of the more ironic arguments offered by the cable operators feeds off of the observation that broadcast networks have carriage rights. They argue that even if cable operators foreclosed their channels to independent programmers, these programmers could sell to the broadcast networks. This ignores the fact that cable operators control the vast majority of video distribution capacity. There are approximately 60 channels per cable operator on a national average basis (Federal Communications Commission, 2002b, p. 10). There are approximately 8 broadcast stations per DMA on a national average basis (BIA Financial, *Television Market Report*, 2002). Each broadcast station has must carry rights for one station. They can bargain for more,

particularly in the digital space, but the cable operators control more stations there as well. In other words, if we foreclose 85 percent of the channels, the programmers will be able to compete to sell to the remaining 15 percent of the channels. Needless to say, this prospect does not excite independent programmers.

[165] Powell, Michael, *Washington Post*, September 11, 2003.

[166] Comcast. The target of the Comcast paper is a short study prepared in January 2003 entitled *Cable Mergers, Monopoly Power and Price Increases* (Washington, DC: Consumer Federation of America and Consumers Union, January 2003). This critique ignores several much longer documents including Consumer Federation of America, "Comments of the Consumer Federation of America, Consumers Union, Center for Digital Democracy, The Office of Communications of the United Church of Christ, Inc., National Association of Telecommunications Officers and Advisors, Association for Independent Video Filmmakers, National Alliance for Media Arts and Culture, and the Alliance for Community Media," 2002; and "Reply Comments of the Consumer Federation of America, Consumers Union, Center for Digital Democracy, and Media Access Project," 2003; Federal Communications Commission, *In the Matter of Implementation of Section 11 of the Cable Television Consumer Protection and Competition Act of 1992, Implementation of Cable Act Reform Provisions of the Telecommunications Act of 1996, The Commission's Cable Horizontal and Vertical Ownership Limits and Attribution Rules, Review of the Commission's Regulations Governing Attribution of Broadcast and Cable/MDS Interests, Review of the Commission's Regulations and Policies Affecting Investment in the Broadcast Industry, Reexamination of the Commission's Cross-Interest Policy*, CS Docket No. 98-82, CS Docket No. 96-85, MM Docket No. 92-264, MM Docket No. 94-150, MM Docket No. 92-51, MM Docket No. 87-154; and Cooper, Mark, *Cable Mergers and Monopolies: Market Power in Digital Communications Networks* (Economic Policy Institute, 2002).

[167] NCTA.

[168] Katz, Michael, *An Economic Analysis of the Claims made by Dr. Mark Cooper in "Cable Mergers, Monopoly Power and Price Increases,"* Commissioned by Comcast Corporation, July 28, 2003 (hereafter Comcast).

[169] "Testimony of Gene Kimmelman," *Senate Commerce Committee*, May 6, 2003, cited in ESPN, p. 4.

[170] Thinking about the cost of viewing to the public leads to another conceptual problem in the NCTA and Comcast analyses, one that has been recently highlighted by the ESPN analysis. ESPN points out they improve quality and increase audiences to increase their ability to sell advertising, as well as get more subscription revenues. Cox II, p. 6, nets advertising out from the cost of programming cable operators incur. That may make sense from the cable operator point of view, but not necessarily from the consumer point of view. Consumers have to watch the commercials and, ultimately, the cost turns up in the goods and services they buy. From a total social welfare analysis, the cost of advertising needs to be attributed to the cost of the total viewing time. The advertising revenue can be handled in a variety of ways, but it cannot be ignored.

[171] Unfortunately, in 1996 the FCC shifted from a January cable price to a June cable price in its annual reports on cable prices. However, we can use the CPWE to interpolate from June to January and only slightly underestimate the actual price increase (since quality adjustments over any short six month period are relatively minor). To the extent the industry was adding channels, this approach underestimates the price increase.

[172] The explanations that cable industry executives gave the GAO for the social welfare superiority of bundling assume that advertisers irrationally pay for homes passed, rather than eyeballs watching, and that consumers maximize their welfare by subsidizing their neighbor's viewing habits. Those claims are inconsistent with the data in this paper (U.S. GAO, 2003, pp. 34-37).

[173] Cox, Appendix.

[174] The example offered by Cox assumes that all fruits and vegetables are equally valuable to consumers in exactly the same quantities.

[175] Guiltinan, Joseph P., "Price Bundling of Services: A Normative Framework," *Journal of Marketing.* Vol. 51. 1987, p. 75.

> Consider, for example, a case in which we have two products or services and can estimate the distributions of reservation prices (the maximum amounts buyers are willing to pay) for each product. By bundling the products together, we essentially create a new product. If the two

products are independent in demand, some customers who would only buy one of these if they were priced individually will now buy both products. The reason is that the value these customers place on one product is so much higher than its price that the combined value of the two products exceeds the bundled price. In economic terminology, the consumer surplus (the amount by which the individual's reservation price exceeds the actual price paid) from the highly valued product is transferred to the less valued product.

[176] Levy, Jonathan, Marcelino Ford-Levine and Anne Levine, *Broadcast Television: Survivor in a Sea of Competition* (Federal Communications Commission, OPP Working Paper, September 2002), p. 62; Albararan, Alan and Angel Arrese, "Time and Media Markets: An Introduction," in Albararan and Arrese (Eds.), *Time and Media Markets* (Mahwah, NJ: Lawrence Earlbaum Associates, 2003), p. 2.

[177] Veronis Suchler Stevenson, *Communications Industry Report*: *Forecast Summary, 2003*, p. 48.

[178] Deutsche Bank, *Walt Disney Company*, October 27, 2003.

[179] This assumes that the non-avid sports fans would pay nothing for it, given the choice.

[180] USPIRG, *The Failure of Cable Deregulation: A Blueprint for Creating a Competitive, Pro-consumer Cable Television Marketplace* (August 2003), pp. 18-19.

[181] Contrast Federal Communications Commission, 1998, Appendix B, and Federal Communications Commission, 2002a, Appendix B.

[182] Cox, Comcast and ESPN also focus on a short time frame.

[183] Federal Communications Commission, *Report on Cable Prices*, In the Matter of Implementation of Section 3 of the Cable Television Consumer Protection Act of 1992, Statistical Report on Average Rates for Basic Service, Cable Programming and Equipment, MM Docket No. 92-226, January 2, 1997, p. 7.

[184] FCC, Report on Cable Prices, 1997, p. 7.

[185] U.S. GAO, 2003, p. 26.

[186] Federal Communications Commission, *In the Matter of Annual Assessment of the Status of Competition in Markets for the Delivery of Video Programming*, Fifth Annual Report, December 23, 1998, Table B-7; Ninth Annual Report, December 2002, Table 4.

[187] We report both revenue per subscriber and the total revenue because some costs are not incurred on a per subscriber basis.

[188] Cox II, p. 8.

[189] Federal Communications Commission, *Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, Ninth Annual Report, p. 15; Seventh Annual Report; NCTA, *Cable Pricing: Value and Cost*, May 2003.

[190] Federal Communications Commission, *In the Matter of Annual Assessment of the Status of Competition in Markets for the Delivery of Video Programming*, Fifth Annual Report, December 23, 1998, Table C-1; Ninth Annual Report, December 2002, Table B-1.

[191]NCTA, Overview 2003: Mid-Year, p. 12.

[192] ESPN, p. 12.